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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

A turbulent quarter for markets has ended with equities more than giving up the ground gained in the first quarter to end the half year with a negative year to date return. There has been a wide variation of performances in the international bond markets, reflecting a flight to quality and away from the weaker eurozone following the sovereign debt crisis which started in Greece. This has also impacted on the euro which has endured a very poor quarter.

The tables below detail relevant movements in markets:

International Equities 31.03.10 - 30.06.10

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-11.6	-17.5	-18.6	-10.1
Finland	-18.0	-24.7	-25.7	-18.0
France	-9.0	-16.5	-17.6	-9.0
Germany	-2.9	-10.9	-12.1	-2.9
Hong Kong, China	-5.6	-4.5	-5.8	+4.0
Italy	-12.6	-19.8	-20.9	-12.6
Japan	-14.7	-8.7	-10.0	-0.6
Netherlands	-8.5	-16.1	-17.2	-8.5
Spain	-12.3	-19.5	-20.6	-12.3
Switzerland	-9.1	-10.1	-11.3	-2.0
UK	-12.8	-12.8	-14.0	-5.0
USA	-11.6	-10.4	-11.6	-2.3
Europe ex UK	-8.0	-14.4	-15.6	-6.8
Asia Pacific ex Japan	-6.8	-10.0	-10.7	-2.0
Asia Pacific	-10.8	-9.4	-10.7	-1.3
Latin America	-10.4	-10.9	-12.1	-2.9
All World All Emerging	-6.0	-6.5	-7.8	+1.9
The World	-10.8	-11.3	-12.5	-3.3

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +4.5%

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

Currency	31.03.10	30.06.10
Sterling	3.95	3.35
US Dollar	3.84	2.96
Yen	1.41	1.09
Germany (Euro)	3.09	2.58

Sterling's performance during the quarter ending 30.06.10 (%)

Currency	Quarter Ending 30.06.10
US Dollar	-1.5
Canadian Dollar	+3.0
Yen	-6.6
Euro	+8.8
Swiss Franc	+1.0
Australian Dollar	+6.8

Other currency movements during the quarter ending 30.06.10 (%)

Currency	Quarter Ending 30.06.10
US Dollar/Canadian Dollar	+4.6
US Dollar/Yen	-5.2
US Dollar/Euro	+10.4
Swiss Franc/Euro	+7.7
Euro/Yen	-14.1

Significant Commodities	(US dollar terms) 31.03.10 - 30.06.10 (%)
Oil	-9.3
Gold	+11.2

Markets

After four quarters of positive returns, international equity markets have endured a setback in the second quarter of 2010. In total return terms, the FTSE World Index has shown a negative performance of 10.8%, in sterling terms it was 11.3%, in US dollar terms it was 12.5% and in euro terms it was 3.3%. Looking at local currency returns first, Japan, of the major areas, was worst affected, returning -14.7%, followed by the UK at -12.8%, the USA at -11.6% and Europe ex UK at -8.0%. Latin America, Asia Pacific ex Japan and Emerging Markets, consistently good performers in recent times, performed less badly than the FTSE World Index, with returns of -10.4%, -6.8% and -6.0% respectively. Elsewhere, Australia, in recent times a very profitable market, suffered a politically driven underperformance as the government threatened the mining sector with a supertax on their profits. Currency factors were important in adjusting the returns of investors, depending upon their base currency. As we can see from the performance of the FTSE World Index in various currencies, the returns for euro based investors were enhanced by the significant weakness of the euro. For sterling investors, investing internationally, comparing returns in local currency terms with the return on the relevant sterling adjusted FTSE World indices, the underperformance of the Japanese market in local currency terms became an outperformance in sterling terms because of the strength of the yen. To a less marked degree, the returns on the FTSE USA index reflected the same phenomenon. Conversely, marked weakness in the euro meant that the local currency outperformance by the FTSE Europe ex UK index turned into an underperformance in sterling terms.

As the table above shows, there were some significant movements in the currency markets. Turbulence in the eurozone caused the pound to rise by 8.8% against the euro, whilst the even stronger US dollar rose by 10.4% against it. The weakness of the Australian dollar, partly caused, no doubt, by the political row concerning the proposed mining super tax, was also a feature, with the pound rising by 6.8% against the Australian dollar.

One of the most astonishing moves was by the Swiss Franc, which was a huge beneficiary of the eurozone's woes, although the Swiss central bank will not see it that way. The Swiss central bank's efforts to restrain the rise in the Swiss Franc were not successful. It rose by 7.7% against the euro over the quarter, whilst sterling's gain against the Swiss Franc was limited to just 1.0%.

The concerns about eurozone sovereign debt problems caused major movements in government bond markets. We will talk later in this review about the weakness in the bonds of the eurozone's perceived riskier credits, but the astonishing decline in yields shown in the table above reflects a flight to perceived quality. Within the eurozone, Germany is, of course, the premier credit, despite its internal political problems, particularly for the Chancellor. The gross redemption yield on the ten year bond fell by 51 basis points to 2.58%. The other three countries in the table, the UK, USA and Japan, are all heavily indebted but, at the moment, all things are relative. Rather improbably, certainly before May's General Election, the UK is now regarded as a safe haven. Although the UK's budget deficit is frightening, the coalition government's move to eliminate the structural deficit over the full life of the current parliament has been well received and concerns about the loss of the coveted AAA rating have abated. Ten year UK government bond yields fell over the quarter by 60 basis points to 3.35%. Because the US dollar is by far the world's largest reserve currency, it has been temporarily protected from its own over-indebted situation and the US government ten year bond yield has fallen by an incredible 88 basis points during the quarter to 2.96%. The Japanese government bond market, often a law unto itself, also saw a dramatic fall in the JGB ten year bond yield by 32 basis points to 1.09%, this despite Japan's very bad debt profile. All of these countries' bond markets had something going for them, albeit in a relative sense, whilst weaker eurozone credits were perceived to have nothing going for them.

In the commodity markets, gold was a beneficiary of currency instability, rising by 11.2% over the quarter, but oil eased back by 9.3%.

Economics

Investors have endured a roller coaster of a second quarter after a solid performance in the first quarter of the year. Problems which have been apparent, such as the looming sovereign debt crisis which had a short term impact on markets in the first quarter, when Greece took the headlines, assumed much greater importance in the second quarter as concerns about sovereign debt spread to other members of the eurozone such as Spain, Portugal, Italy and Ireland. Perceived better quality borrowers, such as Belgium, even though it has a high overall level of public debt, also witnessed strain in their bond markets, although not to the extent of the countries mentioned above. On the other hand, countries viewed as much safer credits benefited from this flight to quality and there were notable falls in government bond yields in Germany, the USA, UK and Japan. This latter group of three is a rather surprising one, given the debt levels of the USA, UK and Japan, but having their own currencies is being seen as a significant advantage for these last three countries against the straitjacket which is strangling the heavily indebted eurozone countries. Being able to "print" a country's own money is seen as an advantage.

The current economic and financial problems have brought out the worst in the politicians who, seemingly unable to control events, have hit out in all directions, playing the blame game very hard. And, of course, many of the incumbent governments are in serious trouble, with their electorates in an angry mood. At the other end of the spectrum, in a country which has weathered the economic and financial storm well, Australia, we have seen a spectacular own goal from the government with its proposed super tax on the mining companies, announced without prior consultation and full of danger for Australia. As the implications became clear, the Prime Minister's poll ratings plummeted. Sometimes the electorate is more intelligent than politicians give it credit for and can see through populist measures to the true and unwelcome consequences. This policy error has been a major contributor to the downfall of Kevin Rudd and his successor, Julia Gillard, has brokered a more acceptable arrangement for the mining industry. Chinese policy makers, in many respects, seem an oasis of common sense when it comes to economic management, albeit under a different system. We will return to Australia later.

The biggest problem area, and one which has shown politicians in a bad light, is Europe, specifically the eurozone. For Mrs Merkel, in Germany, the eurozone sovereign debt crisis has been a disaster. From becoming regarded as a safe pair of hands, when others had been regarded as having a rather uncertain hold on economic reality, she has become deeply unpopular as Germany has promised to contribute to the Greek bailout, something the German electorate deeply resents. In reality, Mrs Merkel is paying the price for her political predecessors who were the partners in the creation of monetary union, a project which was flawed from the start and which was eventually bound to experience severe and, quite possibly, fatal problems. She has been dealt an extraordinarily bad hand and it is difficult to see anything but problems for her. The lack of a democratic mandate for Germany to abandon the Deutschemark is a millstone round the neck of German politicians. The German electorate, almost certainly, would not have wanted to abandon the Deutschemark, had it been asked, and now, understandably, appears more interested about what happens to Germany rather than other members of the eurozone.

We remain very doubtful if the eurozone can survive in its present form. Eurozone politicians are likely to be the last to suggest a dissolution or recasting of the eurozone, if only because many of them are still associated with the project and doing a volte face is very embarrassing. But sooner or later, if monetary union has not already imploded, a breed of politicians will emerge who question the benefits of being tied to a single currency and this will happen because some electorates in the eurozone will question why they are having to make the economic sacrifices which are necessary to make the project work or support weaker eurozone members.

We will discuss the difficulties of individual eurozone countries later in this review but, for now, let us look at the general picture in the eurozone. Until fairly recently, although there were differences in, say, eurozone bond yields as a measure of relative risk between the different eurozone credits, they were not that significant and, as a broad generalisation, one could say that investors regarded the euro as seamless, so that the country backing the credit, whether it be Greece or Germany, was not a significant issue for the investor. How different is the current situation regarding eurozone credits! Germany remains the best credit in the eurozone and, if we look at the yield differentials on eurozone government bonds, we see how serious is the current stress. The German government ten year bond currently has a gross redemption yield of 2.61% and the yield spreads, over this benchmark, range between, at the low end, Netherlands at 20 basis points and Greece at the top of the range, 773 basis points. Those countries which have well known debt issues show substantial spreads, Portugal at 294 basis points and Italy at 148 basis points. In many ways as disturbing is the yield premium which France, a G7 member, the second largest eurozone economy and an AAA rated credit, is showing namely a 38 basis point premium over the German ten year bond. That gap in yields shows a good deal of investor nervousness about France, even though it maintains its AAA rating. That may be to do with the fact that France seems less keen on economic retrenchment than some other countries in the eurozone and, with a forecast deficit of 8% of GDP this year and economic forecasts for growth which the IMF and European Commission see as rather optimistic, it is understandable.

In recent weeks, the eurozone's attitude to deficit reduction has hardened. Before major concerns spread from Greece to other southern European eurozone economies, there had been a more relaxed attitude to deficit reduction and that was also a feature in the UK of the outgoing government's attitude to deficit reduction. These more relaxed views were based on the belief that early action to make a significant reduction in budget deficits would risk economic recovery. In the UK, for example, before the recent General Election, economists lined up their letters to the newspapers arguing, in some cases, for early action on the deficit and, in others, for a delay, because of the dangers to economic growth. In our view, the reason why delay in cutting deficits could be dangerous, is the markets. Whilst one may understand but not agree with the latter group of economists' argument for delay, the deficits have to be funded and, if investors in government debt lose confidence in a country, the effect can be devastating. So, in the eurozone, concerns about the Greek debt contagion spreading to, say, Spain, an economy four and a half times larger than that of Greece, were a real wake-up call for eurozone governments and, now, there seems almost to be a race to see who can be the most austere. The idea that deficit reduction can be delayed has been killed by the fears of a market induced debt crisis.

It is the nature of politicians to put off unpopular measures as long as possibly for fear of damaging their re-election prospects. The Financial Times recently referred to a comment by the Cour des Comptes (Court of Auditors) in France last year that the French government has a long history of basing its fiscal consolidation plans on rosy growth scenarios that seldom materialise. The government then postpones its deficit reduction measures to later years and what has happened is that France continually runs budget deficits and, according to the Financial Times, France has not run a balanced budget for at least three decades.

Now, however, a number of eurozone countries have run out of time and severe deficit reduction measures are being announced, which will come as a shock to many of the population of the affected countries. Spending cuts, tax increases, higher pension contributions and later retirement ages are being announced. There is also some labour market reform being announced in countries like Spain. One of Europe's big disadvantages is its inflexible labour market of which Spain is one of the most rigid, so changes there will upset long established practices but will be a necessary supply side reform to increase the economy's long term growth potential.

Of themselves, the severe austerity packages being introduced by a number of eurozone governments can be expected to have a deflationary impact. Wages and prices are likely to experience downward pressure compared with what they might otherwise have been and, for those southern European eurozone countries which have experienced a loss of competitiveness since the euro came into being or from when they joined the euro, that is a cost of being in monetary union. If monetary union is to survive, those countries which have lost competitiveness will have to regain it. This will mean that their relative price levels against, say, Germany will have to decrease. For countries like the UK, for example, which have retained their own currency, devaluation, in conjunction with deficit reduction measures, can help to provide a short to medium term solution to their problem, as devaluation provides a competitive boost to their industries, either through enhanced export opportunities or import substitution.

Unhappiness is the common theme which unites eurozone countries. Of the strong countries in the euro, Germany is very dissatisfied with the performance of countries like Greece, and the German electorate is furious that it is having to help out Greece. The austerity measures just announced by the German government add insult to injury as far as the German electorate is concerned. Economists point to the high savings rate in Germany and suggest that, if Germans consumed more, it would help to boost demand in the weaker eurozone economies. This will not happen but, even if it did, there is no guarantee, and in fact it is highly unlikely, that the weaker eurozone economies would benefit. As we said earlier, the German electorate has already expressed its displeasure with the government over its agreement to help to bail out Greece. It is yet possible that the German Constitutional Court will block transfers, but that will be for the future as the Court did not grant an injunction to the German economic professors when they tried to block the move.

With all the opprobrium which has been heaped upon the German government for its participation in the bailout of Greece, one might ask why it agreed to participate. The overt reason is support for the eurozone. After all, Germany was one of the architects of monetary union and it would be very embarrassing being a direct party to its collapse. The covert reason is the exposure of the German banking system to Greek debt. If Greece were to default, the contagion would spread, and there are much more important eurozone countries, like Spain, which is, as we said earlier, four and a half times the size of Greece. So the German government, knowing the facts, had no option but to participate.

Until recently, it was regarded as a heresy to talk about the possible break up of the eurozone, but that is no longer the case, at least amongst those not directly involved in eurozone governments or institutions. Now, there is talk of it possibly happening in one of two ways. The one that might be expected would be that the weaker members would leave, either causing the eurozone to collapse or to form a hard core of the financially more solid members, led by Germany. At the other end of the range of possibilities, and the one which has only just started to be talked about, is that Germany and other stronger eurozone members might leave. The Deutschemark and other hard currencies would then be effectively revalued against the currencies of the other members, but liabilities would be in the weaker currency, the euro. That seems very simple to say and, whatever happens, there would be enormous complications, but it would seem to be better than weaker countries leaving, perhaps to return to their legacy currencies but having liabilities in the stronger euro and defaulting.

On the other hand, in what would be a very messy situation, if the weaker countries stayed in but experienced years of deflationary measures to try to restore their competitiveness, they risk chasing their tail as the deflationary measures affected growth or caused a contractionary spiral in the economy which affected government revenue and made the servicing and repayment of debt very difficult. Such is the scale of the adjustment measures needed that major social unrest would seem likely in some of the southern European eurozone countries. Ireland, the first country to adopt severe corrective measures, may be the one which can work its way out of this problem without severe civil unrest, but indications elsewhere in the most indebted countries are not good at present.

To put figures on the problem and to see why there is no easy solution to the eurozone's problems, we can quote figures from the Bank for International Settlements (BIS) showing European banks' exposure to Greece, Portugal, Ireland and Spain. In December 2009, exposure to Greece amounted to €188.8 billion, to Portugal €240.7 billion, to Ireland €638.3 billion and to Spain €856.0 billion. Of these amounts, French banks' exposure was €399.8 billion and German banks' exposure was €514.2 billion. That of UK banks was €341.0 billion with over half of that to Ireland.

So against this background, what of the immediate future for the eurozone? In terms of access to international capital markets, a prerequisite would seem to be that countries should be seen to be making serious attempts to put their house in order as far as borrowing is concerned. Although there may be different nuances, investors in government bonds will no longer find it acceptable to tolerate some delay in taking measures to reduce budget deficits on the basis that to do so would damage growth prospects. That is a theoretical view but, as we said earlier, the flaw in this is that markets will not wait. So what we see at present in the eurozone (and outside it in the UK as well) is a concerted attempt to address the deficit issues as some countries have run out of road. Although Greece is in the worst position, judged by the yield premium on Greek government bonds, many Spanish borrowers are excluded from capital markets and many Spanish banks are having to obtain funding from the ECB.

The ECB will have a crucial role to play in steadying the eurozone ship in these very dangerous times. This will complement the measures announced on 9 May which reflected a rescue package for Greece. The package itself amounted to €750 billion, comprising an increase in the EU balance of payments facility of €60 billion, eurozone bank loan guarantees of €440 billion and IMF loans of up to €250 billion. The ECB reversed its previous policy on bond market purchases and agreed to buy the affected governments' bonds in the market to provide support and liquidity. What it did do to provide some orthodoxy for its actions was to sterilise the intervention, i.e. issuing or selling securities to pay for these purchases as opposed to quantitative easing, or printing money, as has been done in the UK and USA. But we think that, in extremis, the ECB may go further.

We need here to step back and to see how far the structure of monetary union has been dismantled, both wilfully and, now, by circumstances. Once the euro was up and running, the Stability and Growth Pact was the bulwark upon which monetary union was based. The limit on budget deficits was set at 3% of GDP but this was widely ignored when it did not suit. We mentioned earlier what the French Court of Auditors said about French budgetary discipline and when you hope to be elected or re-elected as a politician you do not want to upset the electorate, so tough decisions are postponed. National interests, in some countries, overcame eurozone interests and therein lies a fundamental problem with monetary union. The problems which the eurozone now face were meant to be addressed by the limits on the size of annual budget deficits and of outstanding public debt as a percentage of GDP. If countries stayed within these limits their creditworthiness would be enhanced and the problems which we now see in the credit markets would not exist. The trouble is that these disciplines were not observed.

The latest figures from Eurostat show just how badly eurozone members have strayed from the 3% annual deficit and 60% overall deficit rules. For 2009, Eurostat estimates that, for the eurozone as a whole, the annual government deficit as a percentage of GDP was 6.3%, i.e. over twice the permitted level of the Stability and Growth Pact, whilst government debt as a percentage of GDP was 78.8%, 17.8% over the limit. Within the eurozone, the worst offenders on the annual government deficit as a percentage of GDP basis were Ireland (14.3%), Greece (13.6%), Spain (11.2%), Portugal (9.4%) and France (7.5%). Luxembourg was the best performer with a deficit of just 0.7% of GDP. In terms of government debt as a percentage of GDP, those above the Stability and Growth Pact limit of 60% were Italy (115.8%), Greece (115.1%), Belgium (96.7%), France (77.6%), Portugal (76.8%), Germany (73.2%), Austria (66.5%), Ireland (64.0%) and the Netherlands (60.9%). So the Stability and Growth Pact rules have been observed more in the breach than the observation.

In terms of economics as opposed to politics, monetary union was an incomplete project. If there is to be a single interest rate and a single currency then, for the project to work, there should be a single eurozone government or institution which can decide tax policy and transfers within the different parts of the monetary union. This is euro federalism, something that the electorates are unwilling to accept, as it would mean handing over control of their economy to a eurozone economic government. We can now see some early moves towards such a position with demands being made for EU governments to submit their budgets to the EC for scrutiny. Whilst there will be conspiracy theorists who believe that this represents the slippery slope towards a eurozone economic government, one can equally say that other countries in the eurozone have been misled by previously announced statistics (Greece is a case in point) and this has led to the economic mess in which the eurozone finds itself. One could say that, if countries had signed up to the Stability and Growth Pact which they have by virtue of being in the euro, it is not unreasonable to have their budgets vetted so that they do not have another Greek problem on their hands, the catalyst for the current crisis.

The eurozone has moved so far from the disciplines upon which it was founded that one feels it might go the distance and use quantitative easing in some form to absorb the debt from the markets and prevent an economic or banking collapse in some countries within the eurozone. In the UK, in the fiscal year 2009/10, quantitative easing effectively absorbed the deficit. The dangers of printing money are obvious and quantitative easing can only be used in the most extreme of circumstances, but the eurozone has come so far and is in so much trouble that this extreme temporary expedient may be used.

The tragedy of these developments in the eurozone is that they are not “black swan” or “volcanic ash” moments. That there would be problems eventually with monetary union was obvious, although how they would manifest themselves was not. The danger now is that the political embarrassment of undoing it or admitting that the concept was flawed is still too much to bear and that further errors will be made.

Is there any good which can emerge from this crisis? There is, and that is that the measures being taken to reduce budget deficits, whether or not they prove fatal to the euro project, and whatever other effects they have, for example, defaults, might, in the long term, improve the affected economies. For example, there might be realism on retirement ages where they are unaffordably low, about state spending and the size of the public sector, which is often too large to enable the private sector to have a good long term growth rate, and about the employment market which, in Europe, is often far too rigid, thus denying job opportunities to many because the cost of hiring people can become prohibitive, particularly if the companies have to react to difficult trading conditions in the future. Reforms in these areas could rarely be made in normal economic circumstances but are easier when countries have their backs to the wall. Reform in all these areas holds out the promise of some eurozone economies being able to achieve faster long term growth.

As far as securities markets are concerned, we can look at the eurozone bond market first and, as we noted earlier in this review, there is a very wide range of bond yields reflecting extreme stress in the eurozone bond markets. In absolute terms, apart from Greece, yields looked at in isolation to the others would not look out of the ordinary, assuming that one did not know the background to overall yield levels. German bond yields would probably look rather low and it is, of course, the case that there has been a flight into quality in the German government bond market which has pushed yields to artificially low levels. It is very difficult to see value in the eurozone bond market. At the "safe" end, say Germany and the Netherlands, yields are not attractive, except in so far as other assets are so unattractive that even a sub 3% yield for a ten year bond is acceptable. At the riskier end of the eurozone bond market, yields appear unappealing if there is a risk of a eurozone fragmentation, which we believe there is, or of a default in some credits which is also possible. Although inflation is low at present, any quantitative easing programme could stoke inflationary fears later on which would render current yields unattractive.

Despite the very difficult international economic background and the problems of the eurozone in particular, we continue to believe that eurozone and, indeed, European equities offer much better value. We will be looking at the international economic outlook later in this review, suffice it to say that, whilst very mixed, it is a significant improvement on last year, and next year looks likely to be better still. What are the attractions of European equities when economic growth, as a result of the measures being taken to repair public finances, is going to be very modest and perhaps negative in some of the eurozone countries most badly affected? Firstly, many companies in Europe, and it is important not to forget Switzerland here, as the country is the home to some world class international companies, are very international in the scope of their operations. One by product of the eurozone's problems has been the weakness of the euro and, as in the case of the UK, this provides a boost to companies in the area which have substantial overseas business, either through exports (or will benefit from import substitution) or overseas subsidiaries. The profile of this type of company means that it can avoid the difficulties that many purely domestic companies may be subject to in an environment of sluggish growth. Many of the European companies in our clients' portfolios fit this profile.

The next attraction is that dividend yields are relatively attractive. The word "relatively" is important because, in absolute terms, they are not noticeably high but against euro cash and top quality government bond yields, say those of Germany at 2.75%, they are attractive, especially as we can anticipate growth in dividends over time. Taking dividend yields quoted in the Financial Times in some of the countries represented in our clients' portfolios, we see dividend yields of 3.9% in France, 2.5% in Germany, 3.5% in the Netherlands, 5.1% in Spain and 2.9% in Switzerland. With monetary policy likely to remain loose in Europe, as in many other countries where fiscal policy is subject to substantial tightening, these yields will have some appeal and provide support for share prices. We would, on the evidence about prospects for the world economy next year, expect dividends to grow this year and next year.

Of course, the largest economy in the EU which is not in the eurozone is the UK and, reverting to the Eurostat data we referred to previously in the context of the eurozone, the UK came behind only Ireland and Greece in the levels of government deficits as a percentage of GDP in 2009, with a level of 11.5%. As a percentage of GDP, outstanding public debt stood at 66.1% of GDP, but rising fast given the level of government deficits being accumulated each year.

It is against this background that the UK's new coalition government produced its emergency budget on 22 June. There is a strong irony in the way things have turned out so far since the General Election of 6 May. Like many people, we were concerned in the run up to the General Election that it would produce an indecisive result leading to weak government. We felt that a majority government, which is what UK general elections have normally produced, would have been a desirable result given the severity of the measures which were going to have to be taken to restore credibility to the UK's public finances. No party gave the UK electorate the full story about the severity of the policies needed to rectify public finances and one feared that if, as the opinion polls were suggesting, there was going to be a hung parliament, the inevitable compromises needed to pass the necessary measures through the House of Commons would lack credibility with severe consequences for the pound and the funding of the government's deficit. Combined with this was the fear that a coalition of opportunistic opposition parties could ambush the government at any time and bring it down.

The expected happened in that the General Election result was indecisive but the formal Conservative/Liberal Democrat coalition was unexpected. Although there have been the inevitable compromises, the amount of common ground has been striking, particularly on the all important issue of addressing the horrendous state of the UK's public finances. The reality of power can be bracing and the June 22 budget showed that. We will come to this shortly. The severity of the UK's economic plight, which was apparent for all independent observers to note before the General Election, is matched or exceeded by that of parts of the eurozone and the second surprise is that the UK, at least measured by the performance of the government bond market, seems to be regarded as something of a safe haven. All things are relative, of course, and nothing can detract from the terrible state of the UK economy, but it has two advantages. The first, as we have just mentioned, is the fact that the UK has a new government which, unless the coalition breaks apart, should be stable and is in a position to deliver the measures necessary to restore public finances. The second, and crucial advantage, is that the UK has its own currency and, therefore, independent monetary policy. The country is not, therefore, in the straitjacket of some of the weaker eurozone economies which, having lost competitiveness, do not have the policy tool of a lower exchange rate. So, just at the moment for these two reasons, the UK looks the safer option whilst attention is focused on the eurozone.

The views of those calling for a delay in implementing the measures to address the serious state of UK and eurozone imbalances have been discredited by the crisis in the eurozone. In the real world, politicians must take notice of markets and a country's creditors and, given the severe state of UK public finances, as outlined above, delaying action would have risked a foreign exchange and bond market crisis and then the ability to set policy would have been taken out of, in this case, the UK's hands. It is much better to be in charge of one's own destiny than have much more severe measures imposed from outside, say by the IMF.

For the UK, maintaining its AAA credit rating is vital. If it lost it, the relative cost of borrowing would rise and, if the economy fell into a Greek situation, it could be shut out of the markets. Just to be downgraded, as has happened to Spain, Portugal and Ireland, for example, is bad enough. The litmus test of the acceptability of the coalition's emergency budget is whether the UK can maintain its top credit rating and, although it is early days, the initial prognosis is good. There is more to come in the way of very tough measures. The autumn spending review will involve substantial cutbacks in government spending, whilst the review of public sector pensions will undoubtedly mean a less generous regime for those involved. But, at the end of the day, having a believable deficit reduction plan is the only way to maintain foreign and domestic confidence. One may argue about the details, or the ratio between spending cuts and tax rises (77:23 in this case), but the objective is not optional.

One excellent innovation of the new government is the creation of the Office for Budget Responsibility, which will provide objective economic forecasts. As Sir Alan Bould suggested, these forecasts are subject to error like everyone else's, but not political manipulation. As such, they should keep future governments in check when it comes to the nation's finances since they will run substantial risks if they try to play politics with the nation's finances, particularly in the run up to General Elections.

In terms of the all important deficit, the forecasts are for public sector net borrowing this year to be £149 billion, £116 billion in 2011/12, £89 billion in 2012/13, £60 billion in 2013/14 and £37 billion in 2014/15 which, if the current parliament lasts five years, will take the UK to the next General Election. Public sector net borrowing is forecast to fall to 1.1% of GDP by 2015/16, with the structural element eliminated by what is planned to be the end of this parliament in 2014/15. The overall level of public sector net debt as a percentage of GDP is forecast to peak in 2013/14 at 70.3%, which, although well below what previous governments aimed for, in the circumstances of today, is acceptable. This is an ambitious target but the UK has been running a structural deficit for too long and the dangers of running structural as opposed to cyclical deficits are now there for all to see. This is a plan which international credit rating agencies should be pleased about, as should investors who are holders of UK government debt, at least from security aspect.

Having impressive forecasts for reducing government debt is one thing, achieving it is another, against a background of measures which will negatively impact on almost everyone. One would imagine that the assumed political unpopularity will impact on the coalition and might well cause strains but, in a situation where the UK has its back to the economic wall, wiggle room is not very great. There have been the inevitable compromises, with the Conservatives having to accept slightly more of the package coming from tax increases and slightly less from expenditure cuts. Liberal Democrats have compromised on other issues, perhaps, most importantly, on the timing of expenditure cuts which pre-election, like Labour, they had wanted to delay. However, the Greek debt crisis persuaded them that immediate cuts were inevitable, so it has not developed into an issue.

From a UK equity investor point of view, perhaps the economic growth forecasts are of most interest. That may seem a slightly odd thing to say in the current environment when minds are focused on tax increases and spending cuts, which will make many individuals worse off, and public spending cutbacks will impact on many businesses. But the bigger picture is important and supports business. The relentless growth of the public sector crowds out the private sector. It has increasingly sucked resources from the private sector which provides the tax base for the economy. As the state is cut back in size, so the private sector should be able to prosper and grow again. In a very tough budget, there were measures to help business, namely a steady reduction in the headline rate of Corporation Tax and some help in National Insurance. If the public sector does not subsume so much of the country's resources then there is the opportunity for the private sector to grow and this is a positive point for UK equities looking forward.

Despite the severity of the emergency budget, the OBR forecasts, if they are anywhere near correct, do point to some economic recovery. As we will see when we look at the international economic outlook, important parts of the world economy are performing well and many British companies, especially large ones, are well placed to benefit from this strong economic performance. The benefit will be in two forms. Overseas profits, because of the weakness of sterling, will benefit when translated back to sterling, whilst manufacturing, although a much smaller part of the UK economy than it used to be, will also be more competitive.

Whilst we have just pointed to the longer term benefits of a shrinking in the size of the public sector, namely that it should increase the potential long term growth rate of the economy, there are short term costs because of falls in disposable incomes caused by tax increases and public spending cuts. But it is necessary to have the latter in order to achieve the former. The OBR has, as a result of the budget, moved down its forecast of economic growth compared with its recent estimate. For this year, the forecast rate of growth is 0.1% lower at 1.2% and in 2011/12 by 0.3% to 2.3%. Thereafter, growth is forecast at 2.8% in 2012/13, in 2013/14 at 2.9% and at 2.7% in the following two years.

The pace and size of the changes which will occur in the UK economy on the path to the restoration of the UK's public finances over the maximum lifetime of this parliament will provoke severe opposition and, very likely, significant industrial unrest. It will be a very testing time for the government and the coalition will undoubtedly become very unpopular. But, as well as the new Office for Budget Responsibility, the discipline of the markets will most likely keep the government from backing down on its debt reduction targets. Any backtracking is likely to cause problems for both bond and equity markets.

Even though the sterling government bond market has behaved well since the General Election, because it believes that the new government is serious about getting to grips with the deficit, it is difficult to believe that top quality sterling bond yields are attractive. A reduction in the forecast for gilt issuance this financial year will help, from £185.2 billion to £165 billion, but the actual levels of gross redemption yields on UK gilts at 3.36% for ten years and 4.16% for thirty years, look unattractive.

For the UK where, unlike in some other countries, coalitions are unusual, there are advantages and disadvantages of such governments. In the UK, for that very reason, people tend to dwell on the disadvantages. But the main advantage in this present parliament is that, having agreed a coalition document, both sides are bound into it. One could imagine that, notwithstanding that the serious state of public finances was not of their making, the coalition government will become very unpopular, but spreading that unpopularity over two parties, which together obtained 60% of the popular vote in the recent General Election, makes the government more robust and less sensitive to political pressure and opposition opportunism. In this way, theoretically at least, there should be a better chance of carrying through the programme.

But, whilst most attention is focused on the actions taken to reduce the deficit, the government has to do everything it can to encourage the private sector, because the rebalancing of the UK economy will require not only cutbacks in the public sector but growth in the private sector. Various measures, including corporation tax rate cuts, were announced in the Budget, but coalition politics inevitably involved compromises with neither party achieving their full objectives but reaching agreements that each party can live with. So, in terms of the big picture, tax increases had to take 3% more of the contribution to deficit reduction and public expenditure cuts 3% less. One of the most contentious issues pre budget was Capital Gains Tax, where the Liberal Democrats wanted to align the rate with Income Tax which, for some taxpayers at the new 2010/11 top rate could have meant a 50% tax rate, one of the most punitive in the world. In the end, the top rate was set at 28%. The point is that, in a very competitive world, especially in areas in which the UK excels, such as finance, the UK must remain competitive in order to protect its tax base. The UK has been losing competitiveness in recent years in terms of the tax treatment of non domiciled UK residents and the new 50% top rate of tax. Too high a capital gains tax rate, again, is a deterrent to business. Equally, in view of what has happened to some of the banks since 2008, politicians and the electorate are looking for some sort of retribution and a bank levy was announced in the Budget to be operative from January 2011 and expected to raise £2 billion a year. This may just be the start. But one must be careful what one wishes for, and there is no point in politicians seeking revenge or trying to curry favour with the electorate if the consequences are malign. Finance is a vitally important part of the UK economy. The EU is already becoming more involved and the UK faces a struggle to maintain its premier standing as an international financial centre. The Alternative Investment Fund Managers directive is another case in point. There are many other countries in the world which would like to capture some of the UK's banking and investment business, to mention two areas of finance, and so self inflicted problems are to be avoided. The litmus test for the coalition was Capital Gains Tax with a vociferous campaign being launched against the Liberal Democrats plans. In the event, the outcome looks closer to the Conservatives' position but it is not ideal.

These issues are very important for investors considering investment in the UK whether through shares or business investment. If part of its tax base is eroded, it makes the task of rebalancing the UK economy even more difficult and the attractions of the equity market less. We are not there yet and the Chancellor made very positive noises about encouraging the private sector but he has to live with the constraints of coalition, the need to give some moral authority to the austerity package which will be felt by the whole country and, of course, the need for money. It is a very delicate balance and, for investors, the UK is probably in the amber zone and the recipient of the benefit of the doubt for investors.

During the quarter, we have had updated economic forecasts from a number of leading institutions including the IMF, OECD and World Bank and we show below selected excerpts from each of them. The first is the IMF, the second is the OECD, and the third is the World Bank.

IMF Projections (world output year over year % change)

	2010 (estimate) %	2011 (estimate) %
World output	4.2	3.3
USA	3.1	2.6
Euro Area	1.0	1.5
Germany	1.2	1.7
France	1.5	1.8
Italy	0.8	1.2
Spain	(0.4)	0.9
Japan	1.9	2.0
United Kingdom	1.3	2.5
Canada	3.1	3.2
Newly Industrialised Asian Economies	5.2	4.9
Russia	4.0	3.3
China	10.0	9.9
India	8.8	8.4
Middle East & North Africa	4.5	4.8
Brazil	5.5	4.1

Source: IMF World Economic Outlook Update - April 2010 (excerpts)

Real GDP Growth

	2010 (estimate) %	2011 (estimate) %
USA	3.2	3.2
Japan	3.0	2.0
Euro Area	1.2	1.8
Germany	1.9	2.1
France	1.7	2.1
Italy	1.1	1.5
Spain	(0.2)	0.9
United Kingdom	1.3	2.5
Canada	3.6	3.2

Accession and Enhanced Engagement Economies		
	2010 (estimate) %	**2011** (estimate) %
Brazil	6.5	5.0
China	11.1	9.7
India	8.3	8.5
Russia	5.5	5.1

Source: OECD Economic Outlook - May 2010 (excerpts)

The latest of the three forecasts detailed in this review comes from the World Bank and an excerpt from their forecasts for economic growth is shown below:

World Bank Forecasts for Economic Growth		
	2010 (estimate) %	**2011** (estimate) %
USA	3.3	2.9
Japan	2.5	2.1
Euro Area	0.7	1.3
Germany	1.3	1.5
France	1.1	1.5
Italy	0.6	1.0
Spain	(0.8)	0.8
United Kingdom	1.2	2.2
Canada	3.4	3.0
Brazil	6.4	4.5
China	9.5	8.5
India	8.2	8.7
Russia	4.5	4.8

Source: World Bank - Global Economic Prospects - June 2010 (excerpts)

If we look at the three sets of forecasts, there are no differences of great magnitude. The USA is set to perform better than other heavily indebted countries. The more flexible nature of the US economy gives it better growth potential than the more rigid eurozone economies. Given the current economic environment, the growth projections for the USA, if they turn out to be realistic, must be considered satisfactory. Not surprisingly, the eurozone is expected to struggle, with growth rates forecast to be very modest. All three organisations' projections agree that, of the biggest four eurozone economies, Spain is going to be in most difficulty, with negative growth this year and very little growth next year. In the circumstances, Japan is expected to perform decently. The UK is forecast to show low growth this year and better growth next year, which broadly chimes in with the UK budget forecasts referred to earlier in this review. Canada, with the strongest financial position of the G7 countries as a result of prudent management of its economy in the period, is forecast to grow well. Its mining industry, as in Australia, has provided invaluable support in these difficult times.

Elsewhere, the outlook is very different, with strong growth forecast, both this year and next, in China, India and Brazil, and a very satisfactory result from Russia. These forecasts show clearly the two-speed nature of the world economy but, from an investment perspective, western investors, apart from direct exposure to these areas, can also gain excellent coverage from multinational companies based in these countries. So it does not follow that very poor economic prospects in a particular country translate into poor stock market prospects.

As the economic forecasts suggest, US economic growth prospects this year and next look quite good at, on average, just over 3% this year and, on average, just below 3% next year, if we look at the IMF, OECD and World Bank forecasts. But, in terms of putting its finances right, the USA is living on borrowed time. It is racking up enormous amounts of debt but has the advantage of being the world's largest reserve currency and the repository for many countries' foreign exchange reserves. Switching wholesale out of US dollars in not an option. Furthermore, the euro does not look an appealing option and there is only so much gold which can be purchased. So, by default, the US benefits as the world's largest reserve currency in the sense that it can get away with lax fiscal and monetary policy in a way that other currencies cannot. Of course, like the UK, it can also print its own money, unlike members of the eurozone. The OECD forecasts its fiscal balance at -10.7% of GDP for this year and -8.9% next year. At present, there seems to be no political will to address the USA's fiscal deficits and, later on, it will become a problem in terms of the currency and inflation. However, given the problems of the eurozone in particular, that is for the future. Towards the end of the quarter, China announced a slight relaxation of its policy towards the renminbi, effectively including the possibility of some modest appreciation against the US dollar. Whatever some US politicians may say about China, the modus operandi of their relationship has suited both countries up to a point. The large Chinese trade surplus, partly occasioned by the renminbi's link to the US dollar which keeps it undervalued, is recycled to the USA to help to finance its deficit. So the USA can go on consuming knowing that China can effectively finance its overconsumption. This is an oversimplification but gives the broad picture. For China, the picture has now become more complicated because of the weakness of the euro, Europe being China's largest export market. China is not a country which will bow to foreign pressure and difficult economic conditions have caused some US politicians to become more shrill in their calls for protectionist measures.

In the USA, some important politicians have been calling for trade sanctions against China if it does not revalue its currency. Politicians have not been covering themselves in glory in many countries recently. With US mid term elections due in November, economic populism has become rife. But, if you are the world's largest debtor nation, it does not seem sensible to antagonise your major creditor, and it is this aspect of economic populism which is so worrying. Although, in many ways, it would be cutting off its nose to spite its face, China has the power, because of its vast holdings of US dollars, to cause the USA major problems. It is worrying that some US politicians cannot see the danger of their grandstanding. Indeed, protectionism, as we have often mentioned in the past, is one of the main dangers to the world economy. China has made some gestures towards pressure from G20 countries to address the currency issue which, as we say, has been complicated by the weakness of the euro. The strength of the Chinese economy has been a cause of concern to the Chinese authorities because of the threat to inflation. Allowing the currency to rise helps to restrain inflation.

When we started to write this review, Kevin Rudd was Prime Minister of Australia, now he is not. From being a very popular Prime Minister, he became a very unpopular Prime Minister. A number of things conspired to make his popularity fall dramatically but, undoubtedly, the tipping point was the sudden announcement of a super tax on mining companies' profits, a tax about which there had been no discussion with the mining companies. This was economic populism at its worst. With an election on the horizon, he probably felt that what was, in effect, an expropriation of mining companies' profits, because the tax was retrospective on projects already started, would play well with the voters. He underestimated the intelligence of the voters, many of whom directly or indirectly have an interest in the success of the mining industry, the strength of which, because of its relationship with China, kept Australia out of recession. Mr Rudd failed to understand some very basic facts. A country has to have a reputation for stability in all sorts of ways, including the tax regime. In a business like mining, which has very long lead times and which requires massive investment, companies have to be able to plan on the basis of a stable tax regime. They factor in expected returns and cash flows. If, suddenly, the government changes the rules after the investment has been made, it damages the economics of the project. So, making Australia, which, previously, had an enviable reputation for stability, one of the highest taxed mining regimes in the world and, furthermore, moving the goalposts retrospectively, was about as crass an act as it was possible to imagine. Countries like Canada, with a much more predictable regime, will benefit. The mining companies campaigned very hard against this new tax, to which the government responded by placing advertisements attacking the companies, a major part of the backbone of Australian prosperity. The collapse in support for the government, not far off a General Election, was enough for the ALP to remove Mr Rudd and replace him with his deputy, who seems more emollient. No doubt, the government will try to recover some face by still trying to raise taxes on mining companies, and it will be difficult to undo some of the damage to Australia's business image, but there is some respite. This is very important for overseas investors in Australia, a market which has provided excellent returns in a difficult environment. In fact, the new Prime Minister, Julia Gillard, has reached an agreement with the mining companies on a compromise situation.

We have seen an increase in anti business rhetoric in many places, including the USA. The tragic accident on the oil rig in the Gulf of Mexico, which claimed lives and has caused massive environmental damage, has caused an eruption of feeling against BP from the President of the USA downwards. At times, it has bordered on xenophobia, with references to British Petroleum, a name it long ago abandoned. The point is that such language does not help to clear up the damage or cap the oil flow, but what such intemperate language does do is to frighten off investment. The USA seems very reluctant to wean itself off cheap oil, but attacks on business may scare off oil companies and limit the supply of oil and raise prices, in due course.

The politicians in the eurozone are playing the blame game hard, with bankers and hedge fund managers in the firing line, as some of the politicians seek to deflect the blame for the sovereign debt crisis in the eurozone. Bashing banks and hedge fund managers seems an easy win, given how angry people are about the repercussions of the problems with some of the banks and bankers' bonuses. The anger is understandable. However, there is no evidence that the actions of hedge funds precipitated the crisis. What is undeniable is that the profligate spending of a number of eurozone governments and the lack of attention to budget disciplines are the reasons for the sovereign debt crisis in the eurozone.

The danger of hitting out at banks by planning additional taxes on them or levies on their balance sheets or taxes on financial transactions is that they will have the opposite effect to that intended. It might make them keener to build up their capital base, necessary up to a point, beyond which it might make them less keen to lend. If the climate becomes too hostile, they might move part of their business to more hospitable countries. In the UK, for example, the levy on banks' balance sheets announced in the Budget risks reducing the attraction of the UK for some banks.

The theme behind this brief tour of countries and regions is that politicians are whipping up anti-business rhetoric which could lead to their taking measures which are damaging to markets. By way of contrast, Canada, a country which had very serious public debt problems in the 1990s and to which countries like the UK, which are in a similar position now, are now looking for inspiration as they try to tackle their mountainous debts, has an attractive mining tax environment and is seeking to attract further investment in that area. With its banks, like those in Australia, having avoided the worst of the banking crisis, Canada is opposing measures which might damage them, like a financial transactions tax which some of the eurozone governments favour. Canadian politicians do not need to promote populist measures which can damage their businesses and, hence, their economy. So, a developing investment theme is to observe the actions of politicians. They do have the power to damage markets.

We have concentrated on a number of themes in this review which we think give important guidance to investors. There are positive and negative developments as one would expect and one needs to look at which way the balance tips.

As economic conditions gradually become less abnormal, we are now reverting in our reviews to detailing individual items of economic and financial news, as we used to do, to show the trends in the main economies. Whilst the balance of individual items of news remains negative, as one would expect with the problems which exist, we have been giving prominence to individual items of news which are positive in order to strike some balance to an unremittingly gloomy background. As the economic forecasts of the IMF, OECD and World Bank suggest, there is some cause for optimism, and it is noticeable that stock markets like that of the USA do now react to individual items of economic news, good or bad. We detail below some of the more positive items of individual news which have been emanating from different countries or regions.

Looking first at the USA, positive figures announced in June included a rise in US pending home sales which were 6% up in April, following gains of 7.1% in March and 8.3% in February. Orders for US manufacturing goods rose by 1.2% in April, compared with a rise of 1.7% in March. Excluding transportation, however, orders fell by 0.5%. The Commerce Department reported that wholesale inventories rose by 0.4% in May, which is the fourth consecutive monthly rise following a rise of 0.7% in March. US industrial production rose by 1.2% in May, after a rise of 0.7% in April. In the services sector, the ISM reported that its index of activity remained unchanged in May at 55.4, with anything over 50 representing expansion. According to the Thomson/Reuters University of Michigan's surveys of consumers, consumer sentiment was at its highest in June since January 2008. The index stood at 76 against 73.6 in May. According to the Chairman of the Federal Reserve, the US economy is on track to grow by 3.5% this year because it believes there is only a "modest" impact from the eurozone debt crisis. This forecast is slightly higher than for the three organisations which we referred to earlier.

Emphasising the two-speed nature of the world economy, official figures showed that Canadian GDP grew at an annualised rate of 6.1% during the first quarter, which is the biggest rise since the last quarter of 1999. As a result of its strength, the Bank of Canada started to increase interest rates by 0.25% to 0.5%. Whilst one would not normally consider a rise in interest rates to be in the "good news" category, any slight return towards normality is to be welcomed.

In the eurozone, Eurostat reported that industrial production rose by 0.8% in April, month on month, making a 9.5% gain, year on year, which meant that industrial output growth, year on year, was more than any month in almost two decades. It was also reported that new industrial orders in the eurozone rose by 0.9% in April, following a 5.1% monthly rise in March. This gave an annual pace of growth in April, which is the fastest for ten years, at 22.1%. The eurozone economic sentiment index rose to 98.7 in June, up from 98.4 in May. Elsewhere in the eurozone, the country reporting the most specific good news was Germany and this is obviously important in so far as it is the largest country in the eurozone, or the EU for that matter. The National Labour Agency reported that unemployment declined by a seasonally adjusted 45,000, month on month, to give a rate of 7.7%, compared with 7.8% in April. German manufacturing orders rose by 2.8%, month on month, in April. Industrial output rose by 0.9% in April, lower than the rise of 4% seen in March but still an improvement. The Ifo's business climate index rose in June to 101.8, compared with 101.5 in May, and this is the highest level since May 2008.

There has also been some encouraging news from Japan. Annualised growth in the first quarter of the year was 5% which was slightly up on the estimate made in May and was higher than generally expected. Core machinery orders rose by 4% in April following a 5.4% rise in March.

The strong growth in China is supported by official figures showing that exports rose by 48.5% in May from a year earlier, with imports up by 48.3%, pushing the trade surplus to US$19.5 billion, well above expectations, and, of course, fuelling protectionist sentiment, particularly in the USA. In the UK, activities of British factories increased at the fastest rate for more than fifteen years, showing the same rate of growth as in April. The purchasing managers index was unchanged at 58.0, quite a positive balance. In the housing market, the Bank of England reported that the number of mortgages approved for house purchase in April rose by 2%, the highest figure for a year. There was a significant rise in net mortgage lending from £168 million in March to £490 million in April.

The Nationwide's house price index rose by 0.5% in May, following a 1.1% increase in April, to show a 9.8% increase, year on year. There were signs of better times in the construction sector as well. The Markit/CIPS index for the construction sector rose to 58.5 in May compared with 58.2 in April, and this is the fastest pace of growth since September 2007. The Markit/CIPS purchasing managers index for the services sector rose slightly in May to 55.4, a reasonably positive reading. The British Retail Consortium reported that sales were 0.8% higher in May compared with the same month last year. Internet sales rose by 21.9%. The ONS reported retail sales, including fuel, rising by 0.4% in May, and 2.2%, year on year. In its latest monthly industrial trend survey, the CBI reported that 19% of manufacturers reported total orders were above normal in June, but 42% said they were lower. Manufacturers said that they expected to raise output in the next three months by a balance of 15%.

Just as this review was being finalised, the IMF updated its April forecasts, excerpts of which were detailed earlier in this review. It has raised its forecast for economic growth this year to 4.6% from the 4.2% level in its April "World Economic Outlook", whilst warning that financial market turmoil has increased the risks to the recovery.

As perhaps is inevitable against the economic background which we are witnessing, unsettled periods occur in markets and this quarter has represented such a time. But nothing really unexpected has occurred, just developments of existing issues, and we are concentrating on the reasonable ratings of most stock markets coming into a period when economic growth is expected to improve, albeit from very depressed levels. Volatility is inevitable, and mood swings quite significant, but it is important to focus on the fundamentals which, for equities, we believe to be quite good. Although some top quality bond markets have done well this quarter, benefiting from a flight in bond markets to safety, the resulting yields, shown in the table at the beginning of this review, look too low for normal circumstances, whilst those of lesser quality issues, whilst obviously much higher, do not appeal to us on risk grounds. With so many cross currents affecting the world economy and securities' markets, the issues which we have discussed in this review will provide some pointers to securities' markets movements but, overall, equities remain our preferred asset class.