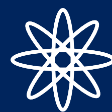

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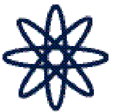


Investment Memorandum

Given all the bad news thrown at stock markets over the quarter, the performance of international equities, although negative over the quarter, must be considered commendable. The ever increasing problems within the eurozone have fed investors with a diet of continual bad news. As our table of high quality ten year government bond yields show, these have been driven down to extraordinarily low levels by a flight to quality and, where relevant, the effects for a long period of quantitative easing. Some good news, however, is the fall in the oil price which, whatever the cause, should put some more money back into the hands of consumers and businesses.

The tables below detail relevant movements in markets:

International Equities 30.03.12 - 29.06.12

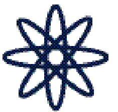
Total Return Performances (%)				
Country	Local Currency	£	US$	€
Australia	-4.4	-3.7	-5.4	-0.8
Finland	-17.9	-20.3	-21.8	-17.9
France	-3.5	-6.3	-8.0	-3.5
Germany	-7.4	-10.2	-11.8	-7.4
Hong Kong, China	-5.2	-3.4	-5.1	-0.4
Italy	-7.0	-9.7	-11.3	-7.0
Japan	-10.0	-5.5	-7.2	-2.6
Netherlands	-3.6	-6.4	-8.1	-3.6
Spain	-7.1	-9.8	-11.5	-7.1
Switzerland	-1.2	-3.9	-5.7	-1.0
UK	-2.4	-2.4	-4.2	+0.5
USA	-2.8	-0.1	-2.8	+2.0
Europe ex UK	-4.3	-6.9	-8.6	-4.1
Asia Pacific ex Japan	-5.4	-4.7	-6.4	-1.8
Asia Pacific	-7.4	-5.0	-6.8	-2.1
Latin America	-6.8	-12.0	-13.7	-9.4
All World All Emerging	-5.0	-7.3	-9.0	-4.5
The World	-4.1	-3.5	-5.3	-0.6

Source FTSE World Indices

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

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

Currency	30.03.02	29.06.12
Sterling	2.21	1.75
US Dollar	2.21	1.66
Yen	0.99	0.84
Germany (Euro)	1.82	1.60



Sterling's performance during the quarter ending 29.06.12 (%)

Currency	Quarter Ending 29.06.12
US Dollar	-1.9
Canadian Dollar	N/C
Yen	-5.3
Euro	+3.3
Swiss Franc	+3.1
Australian dollar	-0.6

Other currency movements during the quarter ending 29.06.12 (%)

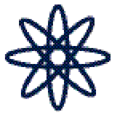
Currency	Quarter Ending 29.06.12
US Dollar/Canadian Dollar	+2.1
US Dollar/Yen	-3.4
US Dollar/Euro	+5.4
Swiss Franc/Euro	+0.2
Euro/Yen	-8.4

Significant Commodities (US dollar terms) 30.03.12 - 29.06.12 (%)

Currency	Quarter Ending 29.06.12
Oil	-20.4
Gold	-6.6

Markets

Considering the economic background, particularly relating to the eurozone's sovereign debt and banking crisis, international equity markets, although lower, have proved to be relatively resilient. In total return terms and in local currencies the FTSE World Index returned -4.1%, in sterling terms -3.5%, in US dollar terms -5.3% and in euro terms -0.6%. Looking at individual country and area performances in local currency terms, we note that the weakest performance came from Japan where the FTSE Japan Index returned -10.0%. There were no other major local currency country or area performances which diverged significantly from the performance of the FTSE World Index on the negative side. On the positive side, there were relatively strong performances from the UK and USA, although down in absolute terms. The FTSE UK Index showed a total return of -2.4% and the FTSE USA Index -2.8%. However, with some reasonably significant currency movements having occurred during the quarter, the picture changed in sterling terms with the yen, in particular, but also the US dollar having strengthened against sterling. There were some changes in relative terms in sterling terms. The negative return on the FTSE Japan Index was reduced to -5.5%, still a worse return than that on the sterling adjusted FTSE World Index but by less of a margin. The FTSE USA Index was barely in negative ground with a return of -0.1%. On the other hand, weakness in the euro and Swiss Franc against sterling meant that the negative local currency return on the FTSE Europe ex UK Index of -4.3% increased to -6.9% in sterling adjusted indices. Weakness in Latin American currencies made for a poor performance from the FTSE Latin America Index in sterling terms, -12.0%, against -6.8% in local currency terms. The FTSE All World All Emerging Markets Index also produced an inferior in sterling terms, -7.3% against -5.0% in local currency terms.



The continued turbulence in the eurozone meant that the flight to perceived quality in the bond markets drove down relevant yields on ten year government bond yields significantly. The UK government bond yield fell by 46 basis points to 1.75%, the US Treasury bond yield by 55 basis points to 1.66%, the Japanese government bond yield by 15 basis points to 0.84% and the German bond yield by 22 basis points to 1.60%.

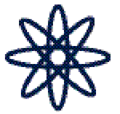
In the currency market, the feature was the yen against which sterling fell by 5.3%. It also fell 1.9% against the US dollar and by 0.6% against the Australian dollar. On the other hand, it rose by 3.3% against the euro and by 3.1% against the Swiss Franc.

In weak commodity markets, oil fell by 20.4% and we will talk about this later.

Economics

For many quarters, the eurozone's economic and financial woes have dominated the headlines and the quarter which has just ended is no different. We always seem to be approaching the end game but the story always seems to find a new twist which delays the final outcome of the crisis for a further period. As this is written, the story which is taking shape is, broadly, Germany (and northern supporting eurozone members) versus the rest of the eurozone, with the latter receiving support from the touchline by an increasing vocal group of onlookers (broadly non eurozone members of the G20 group of leading economies) who are worried about the collateral damage from the eurozone's sovereign debt crisis on their own economies. For those with elections coming up, like President Obama, the fallout is particularly worrying because, at least in the eurozone, incumbent governments of whatever persuasion have felt the wrath of the electorate when elections have become due. To make a sweeping generalisation, most eurozone members and other interested governments (such as the USA, China and UK) want Germany to get out its cheque book or at least put its creditworthiness at risk by supporting other eurozone members thereby giving Angela Merkel a difficult problem. On the one hand, there is no doubt that Germany is very committed to the European project and the single currency, for which it was a strong advocate, but, on the other hand, it is causing Germany serious difficulties, and Mrs Merkel in particular. Importantly, for a politician who is very responsive to the public mood (the U-turn on nuclear power is a case in point), she will weigh the increasing German public hostility to eurozone existing and potential bail outs. Secondly, although Germany is a very strong economic power, it does not have limitless resources and, each time it participates in, or underwrites, another eurozone member's bailout, it weakens its own creditworthiness. That will mean, in time, increasing interest rates to be paid on its borrowings and perhaps withstanding the loss of its prized top credit rating.

Many observers will have sympathy with Germany. It has kept its costs under control and introduced labour market reforms which have been of great benefit to the economy helping it to remain competitive and thereby keep unemployment down at relatively low levels by eurozone standards (6.7% v. 11.0%). Other eurozone economies have allowed their costs to spiral out of control or public spending to increase at unsustainable rates leading to lack of competitiveness and deteriorating current account positions which make many Germans regard these other eurozone members as feckless. But, at this stage, we need to make three points. Firstly, Germany was one of the prime drivers of the single currency, and it was repeatedly warned that the euro was flawed in the way it was established. At the time, in 1998, Chancellor Kohl was warned that Italy was not ready to join the single currency because of its large amount of outstanding public debt. Many knew that the current economic underpinnings were not in place, but Helmut Kohl, according to Der Spiegel, referred to the "weight of history" becoming palpable on the weekend in 1998 when it was resolved to establish the monetary union. But, the "weight of history" is no substitute for good economics and, allowing Greece to join later on, was an even worse mistake. The second reason for moderating one's sympathy for the German position is that, together with France, it was an early offender in breaking the Stability and Growth Pact, which limited, amongst other things, the size of budget deficits. So, if the number one and two economies in the eurozone breached the pact, it sent a sign to other members. Thirdly, the euro has been a weaker currency than the Deutschemark would have been and this has given Germany a competitive advantage.



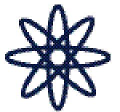
Bearing this in mind, what is the end game? To think through this, we need to detail the flaws in the single currency. All of these can be listed under the umbrella of the eurozone not being an optimal currency area. An optimal currency area will have many common characteristics whether they be economic, structural, social or even political. In economic terms, it might be relative inflation rates, the profile of the economy or the flexibility of the labour, product and services markets which might, for example, give some clues as to the potential growth rate of an economy. Those who argued the economic case for the euro said that it would lead to economic convergence whereas, in reality, exactly the opposite has occurred. The southern eurozone countries and France have experienced a loss of competitiveness against Germany which has manifested itself in their current account deficits. They have not been able to restore their competitiveness by devaluing, as would have been the traditional consequence of a loss of competitiveness. The internal devaluations which the bailed out countries are having imposed upon them are causing great hardship.

So, if those European politicians who were instrumental in the creation of the euro, but who had ignored warnings about the lack of a proper economic underpinning, wanted to create a currency union which might have worked, what should they have done ? The answer would effectively have been to make the eurozone a single economic state, like the USA, where funds could have been moved between the different eurozone countries, as if they were like the states in the USA. This would have meant a fiscal union and that would bring the eurozone effectively to a political union. Although the politicians in most cases managed to avoid asking their electorates if they wanted to be part of the single currency, a political union could not have been created without electoral consent and one could be almost certain that this would not have been forthcoming. It certainly will not be now.

Whilst the eurozone stumbles from crisis to crisis, trying to address the symptoms of the problem rather than the cause, this is not a course of action which can continue indefinitely. The eurozone will break up involuntarily under its own contradictions. The two realistic options are political and fiscal union or an orderly break up either totally or by parts of the eurozone with more logical smaller currency areas. The latter may be pre-empted by a disorderly fragmentation of the eurozone.

How might the fiscal and political union be achieved? So far, the EU has moved in a gradual way towards what politicians describe as "more Europe", not wanting to go at a pace which might frighten electorates. Where they did go too fast, for example in proposing an EU constitution, and were knocked back by the electorates where votes took place, they found an alternative way of proceeding, hence the Lisbon treaty. However, so dramatic are the changes required to move to a political and fiscal union, that these could not be put through by moving in gradual steps. The process would have to be overt, rather than covert, and it is hard to see any of the eurozone's electorates agreeing to this. In what we might call the "creditor" countries, it is hard to see any appetite amongst voters for fiscal transfers to "debtor" eurozone countries. Opinion polls show increasing disenchantment with the EU and the single currency. One practical hindrance might be the German Constitutional Court which pronounces on whether any transfer of powers to the EU is contrary to the German constitution. For example, the radical Left Party in Germany has asked the Constitutional Court to suspend ratification of the eurozone's permanent rescue fund, The European Stability Mechanism, pending a decision on whether it complied with the German constitution. If the "creditor" countries were to agree to make fiscal transfers, it would weaken their credit ratings and push up their relative borrowing costs. The political issue is whether electorates would agree to a greater merger of national identities and the answer there is probably "no".

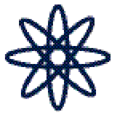
However, there is no doubt that the pressure on Angela Merkel is growing mainly because of the knock on effect of the French election results, which has encouraged "debtor" countries to press for a growth agenda and some easing of the bailout terms. What those pressing for such policies are really saying is that they want more state spending, in the hope that, even if it worsens their borrowing requirement in the short term, it will stimulate activity. This might be a soothing and superficially appealing message to voters but the two objectives are mutually contradictory. There is a hope that "good" borrowing, perhaps for infrastructure spending, can be isolated from



"bad" borrowing to finance countries' structural deficits. Even if the "good" borrowing is mutualised, and that assumes that it could be, the weak position of a number of eurozone countries will impact on the credit risk of the borrower. One measure, opposed by vested interests and some politicians, is an attack on structural rigidities in labour and product markets which exist in many eurozone economies. If meaningful supply side reforms are enacted, it will take time for them to be effective, but they would, in the short term, send out a more encouraging message to business which may stimulate investment and increase employment because the risks are considered to be less. But we come back to the fatal flaw in the monetary union, the inability of individual countries to see their exchange rate float. Devaluation, although it is a policy with problems, would provide the struggling eurozone economies with the means of stimulating economic growth and it is growth which these countries need if they are to restore some order to their public finances and to reduce appalling levels of unemployment. The austerity programmes being forced upon them to address the problem of their public finances are self defeating because they condemn their economies to a downwards economic spiral, which brings us, in our view, to the second and more likely outcome, a fragmentation of the eurozone.

A monetary union, which is as profoundly flawed as the eurozone, cannot survive indefinitely without collapsing under its own contradictions. At the moment, the eurozone is stumbling from crisis to crisis and no one really has any idea how to arrest the chaos, short of examining the causes of the problem rather than taking ad hoc measures to address its symptoms. But the ground has been gradually shifting. Not so long ago, to believe that Greece might leave the euro was regarded as an extreme view. Now, mainstream thinking accepts that, at the very least, it is a possibility. Prior to that, it was widely denied that Greece would default on any of its debt, even though to the market judging by Greek bond yields, it was obvious. In Spain, it was denied that some banks would require a bailout even though analysts realised that this would be necessary. If and when Greece leaves the euro, whatever the politicians may say, the dam will have been breached, meaning it will be much more likely that others will then leave. Many people are not waiting. Money is being moved in large sums from banks in the weaker eurozone countries to the stronger ones because customers of the banks believe that their deposits might be converted to new drachmas, for example, in Greece.

The monies that are available to support bailed out countries, the temporary European Financial Stability Fund and the European Stability Mechanism, are not going to be enough to support the troubled countries and that assumes the latter get off the ground, as touched upon earlier. The pressure is on Mrs Merkel to open up the German cheque book and mutualise eurozone debt perhaps through Eurobonds guaranteed by those eurozone members which are not in receipt of bailouts themselves. Events in France have compounded Mrs Merkel's problems. The new government is pressing ahead with hard ideology rather than economic pragmatism. At a time when retirement ages in Europe and elsewhere are being raised to reflect the financial effects on governments and pension funds of increased longevity, not to mention the effects on governments' finances arising from the current economic difficulties, the decision of the French government to reduce for some people the retirement age from 62 to 60 will be hard to take in Germany, where the retirement age is moving to 67, and elsewhere. The new government's tax and spend policies, together with its anti business and wealth measures, on top of the retirement age issue do not fit in with any mainstream economic view of what will help France to recover economic ground against Germany. With government spending at 56% of French GDP, there are no discernible measures to stimulate growth in France and plenty to suppress it. With 59% of French government debt held overseas, France could become a major issue for the eurozone. France's new government has undertaken an audit of French finances through the Cour des Comptes. The results are now out and they present a stark message to the new French government. It warns that the government needs to make "unprecedented" cuts in public spending and the President of the Cour des Comptes warns that "the government must simultaneously cut not one but two deficits in the public finances and in competitiveness". It is estimated that savings of €33 billion will be needed to hit the deficit target for 2013. The auditor also said that France's outstanding level of public debt could reach 90% of GDP this year and so the warnings go on. The optimistic view is that the hard ideological measures already

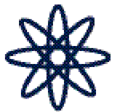


announced by the government before the result of the audit was announced will be used as cover for the very hard spending decisions which France will have to make if it is to meet its budget deficit targets. It has pushed back the time frame for meeting these targets by one year. French ten year government bond yields are about 110 basis points higher than those of Germany and, although historically very low at 2.4%, the gap with Germany does flash some warning lights. Investors will need to keep a careful eye on France because of its idiosyncratic approach to the eurozone crisis and its own issues. It seems unlikely that the electorate will be prepared for what is to come.

Because of the political capital invested in the single currency, it is likely that its disintegration, for that is what we believe will happen, will not occur all at once. Greece will almost certainly have to leave fairly soon. For investors, how this will happen is important. In anticipation of the possible fragmentation of the eurozone, money has been leaving the banks from the weaker members. That is a natural reaction for what would be likely to happen in a country which was about to leave the euro is that it would impose exchange controls and close the banks for a short while, as well as introducing border controls within the eurozone area to stop the flight of money. Bank deposits would then be redenominated into the new currency. Many companies have been making plans for this outcome so, whilst the effect would be serious, the visibility of the fragmentation of the euro has been so high that precautions have been taken, especially by large companies which do business in, say, Greece. Sweeping their cash out of Greece, or other at risk countries, is one action, whilst another obvious one, insofar as it is possible, is to match assets and liabilities in the country as closely as possible. In this fast moving saga, it would be impossible to contain the contagion. Although the eurozone's politicians, bureaucrats and central bankers will emphasise, if Greece does leave, that Greece is a special case and that no other eurozone member will depart from the single currency, markets do not work like that. The next weakest country will be probed, and so it will go on. It must be emphasised that there is no mechanism for a country to leave the single currency. It was supposed to be forever, so its disintegration is bound to be a messy affair. But, for investors, an obvious course of action is to avoid euro denominated bank deposits in the most suspect countries. It is equally important to avoid holding euro denominated bonds in these countries, for two reasons. The first is the risk of default. Market yields suggest that private holders of government bonds in countries other than Greece are going to experience a haircut on their bonds. Although, under the latest iteration of the eurozone agreement the proposed European Stability Mechanism will no longer have preferred creditor status in support given to recapitalising Spanish banks, the Greek experience makes private creditors very wary of the risks they run. The vast Norwegian sovereign wealth fund will no longer hold eurozone sovereign bonds after its experience with its Greek sovereign bond holdings.

We see a different position for eurozone equities, at least for those domiciled in the majority of the eurozone countries. For those companies in a good financial position and with widely diversified businesses internationally, this profile should give them some insurance against a break up of the eurozone. Insofar as their base currency, whether it be the euro or a new currency, is weak against a basket of currencies, it should be helpful to their exports or their overseas earnings when translated back into their base currency. The area currently comprising the eurozone is too big for investors to ignore, notwithstanding its multitude of problems, and there are many excellent companies in which to invest. In many cases, they are in a far better position than their country of domicile to weather the crisis.

The problems of the eurozone are causing great angst everywhere as was shown at the recent G20 meeting. President Obama, facing re-election in November, is anxious about the effect on the US economy, for a weak economy and difficult employment market would be unhelpful to his prospects of being re-elected. In the UK, George Osborne's structural deficit elimination programme timetable is being set back and at least one reason is the eurozone's problems, Europe being the UK's largest trading partner. China, too, is being hit as its exports to the eurozone are affected. The pressure on Angela Merkel is coming from all sides as Germany is seen as the answer to the eurozone's problems. But, the constraints on the German government, both from the Constitutional

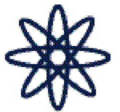


Court and the electorate, are so strong that we think it unlikely that Germany will give way in any material sense, thereby leaving market forces eventually to come to bear on the non optimal single currency area.

One reason why President Obama, if re-elected in November, has an additional concern is that the USA is facing what is termed a "fiscal cliff" next January. This is the consequence of the inability of Congress to reach a meaningful decision on how to tackle the USA's very serious budgetary and public debt problems. That the USA, and the UK to a lesser extent, are not in such a bad position as the eurozone, is besides the point. The USA has very serious problems to address, but it does not face the immediate crisis, which the eurozone does, because it issues and can print its own currency and because the US dollar is the world's largest reserve currency, which other countries have little option but to hold in their reserves. In a last minute deal to avoid a debt default last year as the limit of the debt ceiling approached, a short term compromise was reached but, in the absence of a further agreement, repercussions could be seen from next January which some observers say could amount to a fiscal tightening of as much as 5% of GDP. This would come about because the Bush tax cuts would expire, payroll taxes rise and mandatory spending cuts come into play. At a time when the US economy is expected to grow only modestly, not taking into account the effect of the "fiscal cliff", the eurozone may not grow at all and faster growing economies might be facing reduced, but still excellent, growth by western and Japanese standards. This will be unhelpful to everyone. The problem in the USA, as we have often highlighted before, is the confrontational nature of the relationship between both houses of Congress when control of the House of Representatives and the Senate is split, as at present, and with the Administration. As things stand, there is a good possibility of this impasse continuing after November's elections. There is very little goodwill around and not much interest in compromise. It is very easy to put off dealing with the problem when all eyes are on the eurozone's problems and the US Treasury can raise five year money at about 0.6% and ten year money at around 1.5%, but these yields are a function of extreme distress in international financial markets and a flight to perceived quality even though the USA does not now enjoy a uniform AAA rating. The problem is that politicians' horizons rarely stretch beyond their next election, whereas the problems for the USA are medium and long term ones which, when addressed, will not necessarily endear them to their electorates next time they face them. So, for example, the USA has to make unpopular decisions on taxes and spending, particularly entitlement benefits which threaten to spiral out of control without action, but a politician facing re-election may find few votes in policies which might sensibly address these issues. Paradoxically, what might be best in the short term, given the position elsewhere, particularly in the eurozone, is for bipartisan agreement to extend for a short time the features of the "fiscal cliff" to avoid the contractionary effect of these measures coming into force. This is one example of where, because markets are not putting pressure on the USA, as they are on some countries in the eurozone, it may be sensible to defer action to address the deficit, but it cannot be for long.

A third big issue is China and concerns that an economic slowdown will prejudice international growth prospects. China will still show a growth rate of which the major industrialised countries can only dream but, at a time when many of the major industrialised countries are struggling, its economic fortunes are very important for those countries. China does have the ability to act quickly and it has recently reduced bank reserve requirements, interest rates and it looks as if it is going to bring forward some big capital projects. Never has China seemed more important and markets react to the news coming out of China whether encouraging or discouraging.

But it is not all bad news and the main item of good news is the fall in commodity prices and, in particular, the fall in the oil price. A pessimist might say that it reflects weakening international demand and that is not is a bad sign. It seems that stocks are high and that Saudi Arabia has been pumping oil at a rate which ensures that the price moderates to below US$100 a barrel because it does not want to see an economic recession. There may also be another point. With the advance of fracking, particularly in the USA, there is the prospect of the USA moving towards self sufficiency as it taps "tight oil". Already imports as a percentage of US consumption are falling and this trend is set to continue. Given the importance of oil to the world economy in terms of influencing economic



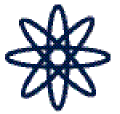
growth rates, a fall in the price of oil is positive. It will reduce the pressure on company profits at a time when demand may not always be strong and a fall in the price of oil will help consumers' purchasing power. With all the bad news round, this is an encouraging development and potentially very important for the world economy and stock markets.

We turn now to look at various areas of the world economy, starting with the U.S.A., where the latest estimate of first quarter growth was revised down to 1.9% from 2.2%. The downward revision was caused by a smaller build up of inventories, an upward revision in the estimate of imports and lower spending by state and local governments. Consistent with this theme of disappointment over growth, the Federal Reserve, after the latest FOMC meeting, reduced its forecast of economic growth this year to a range of 1.9% - 2.4%, compared with last April's projection of 2.4% - 2.9%. The Federal Reserve confirmed its assessment that interest rates would remain exceptionally low until the end of 2014 at the earliest. Its forecast for the unemployment rate was raised from 8.0% - 8.2% for the final quarter of 2012. Despite this downgraded forecast for economic growth, the Fed did not unleash a further bout of quantitative easing but, rather, extended its Operation Twist whereby it sold short dated bonds and bought longer dated bonds. The Fed said, after its meeting, that it would buy securities with maturities of between 6 and 30 years worth US$267 billion, whilst selling securities with less than three years to maturity.

The latest Purchasing Managers Index for the manufacturing sector in the USA fell from 53.5 in May to 49.7 in June, the lowest level in three years. These figures, which are closely followed, suggest the US economy is very sluggish. The latest industrial production figures also showed a very small fall. There has been weakness in retail sales. After a slight downward adjustment to April's estimate of a 0.2% fall, they fell by 0.2% in May. Consumer sentiment is fragile with the Reuters / University of Michigan survey of consumer sentiment falling from 79.3 in May to 73.2 in June, its lowest level of the year. A significant part of the USA's financial sector's woes arise from the housing market and the news has been ambiguous here but the overall impression is that, at least for the present, the position has not worsened. On the negative side, home starts fell by 4.8% in May but the number of permits for new construction rose by 7.9% in May. The latest Case-Shiller index for house prices in twenty of the largest US cities rose by 0.7% in April on a seasonally adjusted basis representing the third consecutive monthly gain. For the USA as a whole, house prices are 1.9% lower than a year previously. The figures for new home sales have also been better. Sales of new style family homes rose by 7.6% in May to give the highest rate since April 2010. Moderating inflation is also helpful in that it should improve consumers' purchasing power. We mentioned the beneficial effect, at least temporarily, of the of the fall in the oil price. The US consumer price fell by 0.3% in May to give a year on year rise of 1.7%. Core prices rose by 0.2% in May to give a year on year increase of 2.3%. Falling oil prices will be positive for corporate profit margins at a time when rising energy prices, as one element of import costs, have put pressure on margins.

Although the USA is a relatively closed economy, it cannot escape the problems elsewhere, particularly in the eurozone, hence the President's increasingly loud call for the eurozone to do something in this election year. The USA's increasingly confrontational politics threatens an accident at some time, just as it did last year over the raising of the debt ceiling. If the Presidency, the Senate and the House of Representatives are not in the hands of the same party, then, unless there is a marked change of attitude, another confrontation over the deficit could occur. It may be that the "fiscal cliff" will concentrate minds but goodwill at the top of US politics seems in short supply. Definitely on the positive side, however, is the trend to self sufficiency in energy as a result of the development of the USA's large supply of shale reserves and longer term investors will recognise this development which can be overlooked amongst all the economic gloom.

Despite its enormous public debt problems, the USA, certainly relative to the eurozone, is seen as a safe haven. Although margin pressure is being seen in US companies, their earnings remain at high levels and the dividend experience remains positive. The issue of dividend payments is important because, with such low yields available

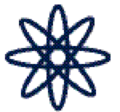


on high quality government bonds, their sustainability is important. 30 year US Treasuries are currently showing a gross redemption yield of 2.6%, above the dividend yield on the S & P 500 Index which is approximately 2.1%. One accepts that US Treasuries, like other high quality government bonds, are grossly overvalued on any normal evaluation basis and therefore highly risky, not in a qualitative sense since, unlike eurozone countries, the USA is master of its own currency, but in a price sense since a return to more normal yield levels would mean large price falls. US dividends, unless something extraordinary happens, are likely to rise substantially over the period to these bonds' redemption date. In these unprecedented circumstances, having a stake in a real asset, such as a high quality company, is a more attractive option than most alternatives.

Whilst, as even the Federal Reserve forecasts show, the USA will almost certainly show some modest growth this year, the same is not the case for the eurozone. The latest OECD projections, made in May, suggest that the eurozone will contract by 0.1% this year and nothing which has happened since then suggests that this forecast is too pessimistic. The austerity measures in place in the weaker eurozone countries bear down on growth prospects. The countries in the most trouble are, unsurprisingly, forecast to contract this year, Greece by 6.9%, Portugal by 3.2%, Spain by 1.6% and Italy by 1.7%. Only Ireland was projected to grow by a modest 0.6% and that may be too optimistic. Germany, the powerhouse economy, which grew by 3.1% in 2011, is projected to grow by just 1.2% this year. Items of individual news about particular eurozone economies are generally of little consequence given the magnitude of the crisis facing the area. An exception may be France which is following an idiosyncratic economic policy and, sooner or later, will have to confront economic reality and make inroads into the state's level of public spending which has to be pared back if its public finances are to stabilise. The markets will certainly be watching France. Meanwhile, the ECB has reduced its interest rate by 0.25% in early July to 0.75%. Monetary policy is almost out of road in the eurozone and with rates at this level there is little more that the ECB can do unless it is effectively called upon to monetise the eurozone's debt.

As for investments in the eurozone, there are many attractive companies whose fortunes will contrast with those of the country in which they are domiciled. It is a theme which we believe to be valid which is that a good way to reduce risk is to increase the diversification of geographical exposure, not only through direct investments in countries which are growing rapidly but also, indirectly, through western or Japanese based companies which have exposure to these markets. Notwithstanding the dire state of the eurozone's economy, it would be a brave investor who excluded the area from an international portfolio. Shares in European stock markets are very lowly rated and often offer attractive yields.

Because of the economic effects of last year's natural disasters in Japan, some growth has been pushed forward into this year. The latest OECD projection is for growth of 2.0% this year following a contraction of 0.7% in 2011. We discussed earlier moves to address the chronic public debt problem in Japan with a rise in consumption tax from its currently low international level of 5%, eventually to 10% being the main weapon. One of the problems for Japanese companies has been the strong yen but the deterioration in the current account surplus, perhaps even with the prospect of moving into deficit, may cause the yen to weaken. If so, it is likely to help the prospects of Japanese exporters and, through them, their share prices. The shutdown of most of Japan's nuclear generating capacity is increasing the demand for fossil fuels and causing the country to move into a trade deficit, although the country's substantial overseas investments are, for the time being, keeping the current account in surplus albeit at a diminishing rate. The ingredients for a weakening of the yen are these. The Bank of Japan has also increased its activity in terms of further quantitative easing, but, with barely any inflation in the country, it is more difficult to make it effective. The deflationary environment from which Japan has suffered discourages spending of a discretionary nature because of the prospects of goods being able to be bought more cheaply. It is difficult to get the additional money arising from quantitative easing to spread around the economy in a very low/no inflation environment.



The hope is that, whilst some of the world's advanced economies are struggling so badly, the BRIC economies and other emerging markets will grow sufficiently to stop the world economy from falling into recession. That is almost certainly going to be the case. The OECD projections for 2012 suggest growth of 1.6% amongst its members and for next year the current projection is 2.2%. Its forecasts for growth in Brazil is 3.2% and for 2013, 4.2%, for Russia 4.5% and 4.1%, for India 7.1% and 7.7% and for China 8.2% and 9.3%. The forecasts for this year may have to be pared back somewhat because developments since these projections were announced in May suggest slower activity but, nevertheless, the projections compare well with what is expected for the advanced economies.

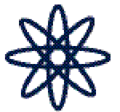
If we look at China, the latest year on year growth in GDP, measured at the end of March, is 8.1%, whilst the quarterly growth rate was 1.8%, continuing a declining quarter on quarter trend which goes back to last September. However, there is encouraging news on inflation, with the year on year figure to the end of May down to 3.0% less than half the rate reached last summer. Prices actually fell in May by 0.3% compared with the previous month. When inflation was much higher, China would not have started to take the measures it has to reinvigorate the economy for fear of worsening the inflation position. Now that inflation has fallen rapidly, the authorities have felt able to reduce bank reserve requirements, lower interest rates (in early July, the People's Bank of China cut the 1 year lending rate to 6% and the deposit rate to 3%) and look to bring forward some capital spending projects. The Purchasing Managers Indices, although in positive territory, meaning they were above 50, have shown a weaker trend in the latest month's figures. The PMI for manufacturing fell from 50.4 in May to 50.2 in June, indicating barely any growth.

Of the BRICS, Brazil has slowed down, with a slowdown in the agricultural sector contributing to the problem. It is expected to show the lowest growth rate of the BRIC economies. Having used exceptional measures to restrain the currency's strength, it now finds the reverse position with the real having weakened sharply. Of concern, is that Brazil has resorted to some protectionist measures to protect its industry, unlike the much more free trade orientated Mexico.

India is a concern. The country appears to be in a state of political paralysis and, with elections not due until 2014, not much action appears to be possible to deal with the problems that are building up in the economy. Structural rigidities have always been a problem, and they have limited the economy's growth potential. It is proving very difficult to take the necessary measures. For example, the government, having announced a liberalisation of the retail market to allow in foreign supermarket groups, immediately caved in to protesting shopkeepers. Another perverse action was retrospective legislation to tax gains made by companies making acquisitions of non Indian companies which held Indian assets. This was in reaction to the Supreme Court supporting Vodafone's appeal against a large tax bill slapped on it. The Finance Ministry brought forward legislation to tax transactions going back to 1962. Retrospective legislation sends out a highly negative message to potential foreign investors and this is reflected in a deterioration in India's FDI figures. India needs foreign investment partly because it runs a significant current account deficit and also because its infrastructure badly needs updating. The sharp fall in the value of the rupee testifies to investors' concerns about India.

For Russia, the OECD projects growth very little changed from 2011 at 4.5% and 4.1% next year. Unlike India and Brazil, Russia has a significant current account surplus which is estimated on The Economist's forecast to be 4.4% of GDP this year. Its budget balance, a slight deficit, is forecast to be in a stronger position than the other BRICS. If the oil price fall is sustained, it would be a less healthy position, but the macroeconomic picture is reasonably robust.

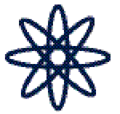
This takes us, finally, to the UK where the position is anything but robust. However, it could be worse and the UK's decision not to join the euro has been an unqualified bonus. The UK has the safety valve of a flexible exchange rate and the ability to print money through its own quantitative easing policy and the UK has used the latter policy option aggressively up to the tune of £325 billion and the Bank of England has just announced an increase to £375



billion. This is one reason why gilt edged yields are at the extraordinarily low levels which we see in the table at the beginning of this review. The second is that the government has been seen as attacking robustly the enormous fiscal deficit and this has contributed to the UK's retention of its AAA rating though it is not certain that it will be able to keep it. The resulting extremely low interest rates have been helpful in containing the financing costs of the UK's public debt burden which continues to rise. The Chancellor's predicament is acute. The UK's current public finances are unsustainable. The size of the deficit and the growing burden of outstanding debt pose a major threat to the UK economy if they are not tackled. In such a situation, economic growth is the desired policy objective to help to contain the deficit because economic growth brings in more taxes and helps to contain public expenditure on outlays such as social security payments. This is where the eurozone's woes are so troublesome for the Chancellor. The lack of growth, possibly even recession, in the area, which is the UK's largest trading partner, has upset the Chancellor's plans and will make the timetable for the elimination of the UK's structural deficit, already extended two years beyond the planned end of this parliament, even more difficult. There are those who call for more public spending than is currently planned so that the deficit is therefore tackled more slowly with the argument being that the extra spending will improve the deficit reduction outcome by stimulating the economy. This is a seductive argument but it is very high risk. If overseas investors in sterling or the gilt market take flight because they believe that the government is backsliding on its deficit reduction plans and bale out of sterling and the gilt market then gilt yields could rise very sharply making servicing of the debt more expensive and causing a sterling crisis. The Bank of England could expand its balance sheet even further than it has just done by expanding the amount of quantitative easing but this would risk debasing the currency and causing very severe inflation. Any Chancellor dealing with a budget deficit as bad as that of the UK (7.8% of GDP this year according to The Economist's forecast) will be fearful of risking a loss of confidence in the UK's economic policy. Once confidence is lost, as we have seen from the level on some of the yields of eurozone government bonds, it cannot be regained.

So, what can the UK Chancellor do? Measures have been announced to improve the supply and cost of funds to businesses which want to borrow but are finding it difficult at present. That could be a help but it is difficult to see it being a game changer. Supply side reforms, which do not cost money, can be achieved which would help modestly in the short term but much more in the medium and long term. By supply side reforms, we mean cutting bureaucracy and red tape which has been growing rapidly in the UK and Europe and is a dead weight on business. Business must have the confidence to hire people with minimal risk and to invest likewise. Lord Keynes' "animal spirits" are likely to be much more prevalent if the risks which businesses face from expanding their workforce and investing in new plant and equipment, for example, are much reduced. Yet politicians seem incapable of tackling one "easy win". In the UK, it must partly be because of coalition politics ; in Europe, it is because regulation is part of a mindset entrenched by vested interests. The shocking levels of youth unemployment seen in parts of the southern eurozone, Spain is a prime example, is due to a heavily regulated labour market which favours those in work at the expense of those, particularly the young, who find it difficult to obtain a permanent job.

Given the dreadful position in the eurozone, the UK must hope for some help from the USA and what broadly would be defined as emerging markets and developed markets in the east. As we have seen, only modest help is likely to be forthcoming. But one ray of sunshine in the UK and elsewhere is the fall in the oil price. It affects so many things. Apart from the fragile state of the world economy which is affecting demand, it seems clear that Saudi Arabia, as the world's largest oil producer, is keen to keep the oil price at a level which does not pose a threat to the world economy and, beyond that, the shale oil promise, particularly in the USA, is encouraging. This latter benefit is a medium and long term issue. For the UK, the Consumer Price Index fell from 3.0% in April to 2.8% in May and the previous measure which was used, the Retail Price Index, from 3.5% to 3.1%. The fall in the oil prices, as long as it lasts, will help to reduce the pressure on household incomes and business costs. Whilst the Chancellor has been roundly condemned for deferring the 3p rise in the petrol price, which was due to come into force on 1st August, and the money to replace the lost tax has to be found somewhere, psychologically it



was a good move because it reinforces the effect of falling fuel prices in people's and businesses minds and might stimulate some spending.

Just as in the eurozone, although the situation is not as bad, there is no magic bullet to turn round the UK economy. It will have to be slow graft. The fiscal situation, because of the extenuating factors mentioned earlier, has the Chancellor locked in a straitjacket. That is why the Bank of England announced a further £50 billion of quantitative easing. With fiscal policy certainly going to have to remain tight, very loose monetary policy is an offset and the prospect of being able to borrow at interest rates which would previously been unimaginable may stimulate some activity. There are, however, more savers than borrowers and an offset to low interest rates for borrowers is the squeeze which it puts on savers whose purchasing power is reduced. There are other negative consequences of quantitative easing, for instance on pension funds, but one benefit which could also provide a ray of sunshine for the UK economy (and others) is the effect on asset prices of very low interest rates. One reason why we like equities as an asset class is that the unattractiveness of bonds and cash contrasts with the current attractive dividend yields of many shares. We can be as certain as we can be that monetary policy in the main industrialised countries is going to remain very loose and this should attract some types of investor towards shares. Rising asset values can create a positive wealth effect which should lead to some improvement in economic activity. Why all these possible straws in the wind are so important is shown in the disappointing government borrowing figures so far this financial year. In May, public sector net borrowing came in at £17.9 billion against £15.2 billion in May 2011. Other recent data has been disappointing, including from the housing market, where house prices, if anything, may be falling, and where net mortgage lending fell in May for the first time on record. The manufacturing purchasing managers index was below 48.6 in June, indicating a weak economy, even though manufacturing is now a small part of the economy.

Notwithstanding the difficult conditions in the UK economy, as elsewhere, we consider the UK equity market to be attractive. The ratings and dividend yields on many shares are appealing and the wide geographical spread of interests of many UK companies gives them attractive defensive characteristics. They can expect to do better than the UK economy and this reaffirms the importance of differentiating companies' prospects from those of the country in which they are denominated.

In summary, our investment review remains the same. The apparent paradox of the reasonably stable equity markets for the year to date, although with periods of volatility, against a seriously troubling economic and financial background, can be explained by the very loose orthodox and unorthodox monetary policy which is being followed in many countries. It explains why high quality bond yields are so extraordinarily low and therefore posing a severe price risk to investors, whilst the dividend yields on equities are relatively attractive. Not all of the world is facing the economic difficulties of the eurozone, so companies based in these economically troubled regions and countries can still prosper. Many corporate balance sheets are in a strong position which means the outlook for dividends is satisfactory. The fact that high quality bonds, in our view, are very expensive means that shares are attractive in relative terms but, in absolute terms, valuations are also appealing. Investors should be under no illusions, however. Shares will be volatile as they react to bouts of even worse economic news or further troubles in the eurozone, so it is likely to be an uneven ride.

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