meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

It has been a quarter of little movement in international equity markets although they ended on a weak note. This is not an unsatisfactory performance given the political economic headwinds which investors have had to face. Bond yields, as measured by high quality ten year government bonds, have fallen further during the quarter as investors, in some cases, have fled to what are perceived as safe vehicles. Currency movements have been quite significant with the US dollar performing strongly. The European and Australian currencies have been weak, with sterling somewhere in the middle. Commodities have been weak. Both oil and gold had significant falls during the quarter.

The tables below detail relevant movements in markets :

International Equities 30.06.14 - 30.09.14

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-0.7	-2.9	-8.0	-0.2
Finland	+5.0	+2.1	-3.2	+5.0
France	-0.7	-3.4	-8.4	-0.7
Germany	-3.7	-6.3	-11.2	-3.7
Hong Kong, China	-2.5	+2.7	-2.7	+5.5
Italy	-0.6	-3.3	-8.3	-0.6
Japan	+5.9	+3.1	-2.2	+6.0
Netherlands	+2.6	-0.2	-5.3	+2.6
Spain	+0.5	-2.2	-7.3	+0.5
Switzerland	+3.0	+0.8	-4.4	+3.6
UK	-0.9	-0.9	-6.1	+1.8
USA	+0.9	+6.4	+0.9	+9.4
Europe ex UK	+0.1	-2.4	-7.4	+0.3
Asia Pacific ex Japan	-0.9	+0.4	-4.8	+3.1
Asia Pacific	+2.3	+1.7	-3.6	+4.5
Latin America	+2.6	-0.2	-5.4	+2.5
All World All Emerging	+1.3	+3.2	-2.2	+6.0
The World	+0.9	+3.1	-2.3	+5.9

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +3.7%

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

Currency	30.06.14	30.09.14
Sterling	2.67	2.43
US Dollar	2.53	2.49
Yen	0.57	0.53
Germany (Euro)	1.25	0.95

Sterling's performance during the quarter ending 30.09.14 (%)

Currency	Quarter Ending 30.09.14
US Dollar	-5.2
Canadian Dollar	-0.3
Yen	+2.7
Euro	+2.8
Swiss Franc	+2.1
Australian dollar	+2.3

Other currency movements during the quarter ending 30.09.14 (%)

Currency	Quarter Ending 30.09.14
US Dollar/Canadian Dollar	+5.1
US Dollar/Yen	+8.3
US Dollar/Euro	+8.4
Swiss Franc/Euro	+0.7
Euro/Yen	-0.1

Significant Commodities (US dollar terms) 30.06.14 - 30.06.14 (%)

Currency	Quarter Ending 30.09.14
Oil	-15.5
Gold	-7.3

MARKETS

International equity markets have shown little change over the quarter. In local currency total return terms, the FTSE World Index has returned 0.9%, in sterling terms 3.1%, in US dollar terms -2.3% and, in euro terms, 5.9%. Looking at local currency returns first, the best performance was from the FTSE Japan Index which returned 5.9%. There were no really bad performers. However, because of significant currency movements during the quarter, sterling returns differed quite markedly in a number of cases. The strength of the US dollar meant that there was a strong return in sterling terms from the FTSE USA Index at 6.4%. Weakness in the yen pulled the return down on the FTSE Japan Index to 3.1% but that was still in line with the FTSE World Index. There was relative weakness in the FTSE Australian Index (-2.9%), the FTSE Europe ex UK Index (-2.4%) and the FTSE UK Index (-0.9%). Within the FTSE Europe ex UK Index, Germany was notably weak with the FTSE Germany Index returning -6.3%. The Russian situation affected the market with Germany considered to be quite exposed.

International bond markets, as measured by the ten year government benchmarks detailed in the table at the beginning of this review, performed well. The gross redemption yield on the sterling bond fell by 24 basis points to 2.43%, in the US Treasury bond by 4 basis points to 2.49%, on the Japanese government bond by 4 basis points to 0.53% and on the German Bund by an astonishing 30 basis points to 0.95%.

As mentioned above, there were some significant moves in the currency markets. Against the US dollar, sterling fell by 5.2% but against the yen it rose by 2.7%, against the euro by 2.8%, against the Swiss Franc by 2.1% and against the Australian dollar by 2.3%.

There were some significant moves in the commodity markets with oil, as measured by Brent crude, falling by 15.5% and gold by 7.3%.

ECONOMICS

The resilience of the international stock markets, notwithstanding weakness at the end of September and beginning of October, continues to surprise many observers. No matter what is thrown at them, they seem to bounce back, although we wait to see if this is the case with the latest setback. Political and military turmoil and continuing serious economic problems within the eurozone have not fazed markets for long. Setbacks have been quite minor and recovery has come quickly. Against this background, one could accuse investors of being complacent with the relatively low levels of volatility supporting this view. Apart from a spike at the beginning of August and end of September, and then not a big one, volatility is not much higher than at the beginning of the third quarter. Should investors be worried? One positive feature to note is the lack of enthusiasm for this bull market in equities. It started in March 2009 so has been running for over 5½ years. Perhaps, because the financial and economic situation looked so threatening at the time, many investors could not bring themselves to believe that shares were cheap and have looked on with increasing disbelief as prices have climbed ever higher. If markets had been propelled higher on a wave of unrestrained enthusiasm one might have been more concerned. As it is, it can quite fairly be called on unenthusiastic bull market. That is good because the speculative element in the market rise is low which may account for the limited setbacks which we have experienced when the news background has worsened. However, having tried to rationalise what has happened to stock markets and the accompanying low volatility, it is important not to be complacent.

Our view remains the same as it has been since the financial crisis developed, namely that the availability of cheap and, sometimes, printed money has sustained asset prices, much as the authors of the policy had intended. However, this rationale for being invested in equities cannot be sustained indefinitely if shares become obviously expensive. By definition, they are not as cheap as they were simply because the rise in share prices has outpaced the growth of corporate earnings. Whilst we think that significant equity exposure is the correct course of action, and that this asset class is not obviously overvalued, we continue to believe that bonds are seriously overvalued. It is true that the bond market has performed well this year but when we are talking about returns made from bonds with historically very low yields the odds are not favourable for making satisfactory returns from here. So far this year it has worked but we still consider that the risk / reward ratio is very unfavourable given that, at some stage, there will need to be some normalisation of yields. The difference between the risk taken in equities and bonds is that, if there is a normalisation of interest rates, the losses incurred by holding bonds will be severe and may never be recovered or, if they are held to redemption, will result in a significant opportunity cost. If equities fall, however, the pain is likely to be more short lived for it is highly likely that they will recover and, at some stage, push on to higher levels.

This argument about the risks of investing in bonds would be wrong if the current level of bond yields such as those shown in the table at the beginning of this review were to become the norm. For investors who have experienced much higher levels of yield on such bonds in the past and, in some cases, double figure yields, this would seem an improbable prospect but, just because it is improbable, it does not mean that it should be ruled out. As we start this review, it is worth examining some of the scenarios for bonds.

In normal circumstances, one would be looking for a real return on bonds. If we look at ten year government bonds as the benchmark and compare current year on year inflation rates (in brackets), we see the current relationship amongst government bonds of the G7 countries - USA 2.49% (1.7%), Germany 0.95% (0.8%), France 1.79% (0.4%), Italy 2.39% (-0.2%), Japan 0.53% (3.3%), UK 2.43% (1.5%) and Canada 2.24% (2.1%). All of them, except Japan, offer real returns on this basis, perhaps not as high as one would expect in most cases but, nevertheless, real returns all the same. From here, one needs to ask oneself if either the absolute level of yield or the inflation rate represents an anomaly. Historically, the nominal yields are very low and one would have to have low expectations of returns from competing asset classes to be satisfied with what is on offer from bonds. But, if one was satisfied with those yields, it would have to be because one took an exceptionally pessimistic view on the prospects for the world economy. There are many political and economic problems as we know but, if we take just one indicator, the international equity market, it does not seem that investors are pessimistic about the economic outlook. They certainly seem to be expecting better returns than implied by the gross redemption yields on the various government bonds just mentioned. Alternatively, if we relate the bond yields to current inflation rates then, whilst rather low in some cases, the level of real yields does provide some support for very low nominal rates. However, inflation rates are exceptionally low and that begs the question as to why this is the case and with particular reference to the eurozone where the phenomenon is particularly prevalent. Inflation can be of the cost push type or the demand pull type. Cost push type inflation comes from upward pressure on employment costs or inputs like raw materials but this would typically occur when the output gap in an economy had been closed, i.e. there is no spare capacity available and businesses have to bid up for staff or raw materials or other inputs. At the moment, this is not the case, particularly in the eurozone. On the other side of the equation, but clearly linked, is demand pull inflation where excess demand enables businesses to raise prices to balance supply and demand. This is clearly not an issue either. So, weak inflation or even deflation, which is being experienced in some eurozone countries at present, can be explained by a lack of cost push and demand pull factors. But it is a much deeper issue than this, certainly within the eurozone, and it is the counterpart of the forces which cause inflation, detailed above. In the eurozone, in particular, deflationary forces are at work. Cost push inflation, as we said, is not an issue. The austerity programmes, through which a number of eurozone countries are going, are not going to push up employment costs, in fact the reverse. Because these countries are linked together in a currency union and cannot devalue their way to competiveness, some are being forced to undertake an internal devaluation which involves, amongst other burdens, pay cuts, the idea being that competitiveness will be restored ultimately by costs being reduced internally relatively to other more competitive eurozone countries. If this happens, then demand is going to be reduced and businesses may have to cut their prices to balance supply and demand. So, in this environment, very low inflation or deflation can occur and we can see this happening in the eurozone at the moment. With austerity mandated for a number of eurozone countries in order that they can make a start in rectifying their public finances and borrowing levels, there is a demand deficiency and, hence, downward pressure on prices.

Prima facie, this may seem to justify the very low levels of yield which prevail in the eurozone. The reason why the thread of the argument seems centred on the eurozone is that this is the area which best explains the phenomenon of low bond yields and the rationale behind it. However, this apparent justification for very low eurozone bond yields does not take into account the credit risk and there are two connected aspects to this. Firstly, in countries with low or no growth or economic contraction and which are running a budget deficit (which will nearly always be the case) deflation or very low inflation will worsen the relationship between the level of outstanding public debt and GDP. This can be seen in an example where, because of deflation and no economic growth, nominal GDP declines whilst the level of nominal public debt rises. This is the so called denominator effect. Secondly, as a result of this worsening of the country's debt dynamics, the credit risk increases and this should be priced into yields. We have been talking about government bonds but the argument, of course, also applies to the private sector. This is why deflation is so feared by economists. If we take Eurostat's data at the end of the first quarter of 2014 for general government gross debt as a percentage of GDP, one can see why there should be concern. Leading the way is Greece with 174% followed by Italy (135.6%), Portugal (132.9%), Cyprus (112.2%), Belgium (105.1%), Spain (96.8%) and France (96.6%). Because of the budget deficits being run, these levels are mostly rising quarter by quarter. In countries like the USA, UK and Japan, which have their own central banks, the printing presses can effectively be run but in the eurozone, where countries joining the monetary union have surrendered that flexibility as well as that of a floating currency, they are at the mercy of the markets. If one looks at the ten year government benchmark bond yields for, say, those countries where the level of outstanding debt exceeds 100% of GDP, we see the following yields, Greece 6.57%, Italy 2.39% (see earlier), Portugal 3.15% and Belgium 1.22%. For France, which will almost certainly be through the 100% level shortly, the yield is just 1.29%. So, whilst it may be possible to justify some of these yields on low inflation /deflation grounds, one has to say that the credit risks do not seem to be taken into account and this also applies to a range of corporate bonds where yields on sub investment grade bonds have been driven down to dangerously low levels. Some of the eurozone two year government bonds have a negative gross redemption yield such as Germany (-0.07%) and the Netherlands (-0.01%). Outside the eurozone, the equivalent yield for Denmark is -0.03% and for Switzerland -0.05%. These reflect extraordinary conditions.

But is inflation dead? It is easy to think that, to go back to the question as to whether deflationary prospects justify current nominal yields, because we have not had to worry about inflation for a while, we will not have to do so in the future. However, it is important not to fall into that trap. Whilst inflation may take some time to appear in the eurozone, that may not be the case in the UK and the USA. Whilst Japan is showing a higher rate of inflation than any other G7 country, this is because of the 1st April consumption tax increase from 5% to 8%. The danger of resorting to the printing press, as central banks have done in the USA, UK and Japan, is that, at some stage in the future, this will lead to inflation. As confidence increases and the money moves off banks' balance sheets to create loans which, in turn, increase business activity and lead to demand for more loans through a multiplier effect, the increased economic activity results is inflation being stimulated by cost push and demand pull factors. Whilst it is harder for central banks to control interest rates out along the yield curve, at the short end they can do so. So, at all the main central banks, we see interest rates at negligible or, in the case of the ECB, at negative interest rates. In the two countries, the USA and UK, which have effected quantitative easing, and are now showing a stronger economic performance than most, the debate it starting to be engaged as to when interest rates should start to be raised. Even though, as the figures earlier show, inflation is low, interest rates, as set by the central bank, are negative in real terms and this is not a healthy situation in other than exceptional economic circumstances. Whilst it is not possible for businesses and individuals to borrow at such a rate because of the margin which banks take, very low real interest rates, or possibly negative ones, can encourage unwise borrowing particularly to invest in assets which may be rising in price and, here, property comes to mind. This is an environment where inflation can take off, hence the expectation in the USA and UK that the relatively strong growth being shown in both countries will mean that the central banks will raise interest rates in the first part of 2015.

Shorter term issues are keeping inflation low. Some commodity prices are being depressed by the slowdown in the Chinese economy, iron ore being a case in point, as China seeks to de-emphasise fixed asset investment at the expense of consumption. Oil prices are also weak as the influence of fracking in the USA bears down on energy prices. However, the turmoil in the Middle East should give no cause for complacency and the sanctions tit for tat against Russia also raises added concerns about energy prices. We should not extrapolate weak commodity price trends into the future.

Whilst very low bond yields could be construed as foretelling a recession or at least a very weak international economy and yields have been held down by quantitative easing, equities, as we said earlier, have been telling a different story and both markets cannot be correct. Whilst the potential rate of growth of the world economy has been weakened by the financial and economic crisis of 2008 and the current travails of the eurozone, partly because the level of public and private leverage acts as a brake on growth, we see no reason to believe internationally that the reduction in growth potential is sufficient to justify the current level of bond yields. Whilst we might accept that the very low nominal yields of ten year eurozone government bonds still offer real yields, we think credit risks are not being correctly priced in. In the badly affected countries, not to mention France and Italy, the number two and three economies respectively, debt levels are still rising and investors will not indefinitely believe that such low levels of yields represent an appropriate return to them. In practical terms, there is a risk to bond investors which has been well aired and that is that, when there is a rush for the door by these investors, reduced liquidity in the market could cause a sharp move in prices. Our conclusion is that whilst the very low level of bond yields is explicable, it is not justifiable on anything but a temporary basis. We do not see enough evidence that we are going to experience a long period of deflation or no inflation and do not believe credit risks are priced in.

We continue to believe that monetary union in the eurozone is not sustainable and that the euro area will fragment. The policies being followed to sustain it are too severe and costly.

It might be worth recording current economic and political news which has the potential to unsettle stock markets. In detailing some of these, we are not suggesting that markets will react badly because one of the most noticeable features of recent market movements has been how little they have been affected by what have been very serious events. As we have noted before, there is always something for investors to worry about. Delaying investment because of concerns about external events can often prove very costly. It is hard to think of a time when investors can truly be said to have a worry free environment. In political terms, there is the conflagration in the Middle East. The humanitarian crisis is in the forefront of people's minds but, in economic terms, the threat to world oil supplies is always real. Increased oil production in the USA reduces the overall risk of a disruption in Middle Eastern supplies but it is still a real threat if the conflagration spreads. Middle Eastern conflict is always with us but the escalation is a major worry. The Ukraine conflict quite clearly has the potential to develop into something even more serious, possibly involving the Western powers militarily against Russia or economically, as two way sanctions affect economic activity either directly or indirectly through weakening economic sentiment. There is already some evidence of this as sentiment indicators in Europe weaken. The eurozone is always a concern because of its poor economic performance and structural issues. Depending upon what is happening elsewhere, it is either at the forefront of investors' concerns or is down the order as some events more immediately come to the fore. There is no room for complacency and it is an economic trouble spot which could flare up at any time. Then there is China where the concerns are of a different order. The growth rate is, of course, one that the west and other regions can only dream of but it is the risks involved in the economy making the transition from one based on fixed asset investment to a more consumption based one that exercise investors' minds. Over investment in fixed assets and property is leaving a nasty hangover. Property prices have been falling and this is causing concerns about the health of the banking industry. Because of its financial strength, China can probably handle a problem with its banks better than most but other countries need China, the second largest economy, to grow at a robust pace. On the health front, the Ebola outbreak could spread. A new concern is the civil unrest in Hong Kong and how China reacts. This is a big list of concerns and one can add to the list, but, so far, the stock markets have dealt with them with equanimity. Of course, to misquote Donald Rumsfeld unknown unknowns could occur at any time and destabilise markets.

What we have mentioned above are continuing situations but what if there is an economic policy shift and how would markets react to that? As everyone knows, asset prices have been inflated by the very loose standard and non standard monetary policy which has prevailed since 2008, this being manifested in very low interest rates and, in the USA, UK and Japan, money creation. However, we are moving towards the time when interest rate rises appear on the agenda of the Federal Reserve and Bank of England so we may see a situation equivalent to the "taper tantrums" which we witnessed briefly last year when the idea was floated that the Federal Reserve should start to reduce its bond buying financed through monetary easing, then at US$85 billion a month. It is a matter of psychology. Everyone knew that the Federal Reserve could not go on printing money indefinitely and that, one day, it would have to stop. One might have expected it to have been priced into the market, but, on two occasions when the market faltered, it was not. As we now know, it recovered its poise and Wall Street now stands not far off its all time high. So what will happen when it looks as if interest rates are about to be increased? Here market signalling looks more important than ever. The latest median federal funds rate projection from the FOMC is 1.354% by the end of 2015 and 2.85% at the end of 2016. So, if the federal funds rate is raised in steps of

0.25% at a time, we might be looking at five increases by the end of 2015 and eleven by the end of 2016. The longer the first increase is delayed, the more quickly or, possibly, the more steeply interest rate increases might occur. The FOMC still says that it will keep interest rates at the current level for a considerable time. So it may be that by the middle of next year rates will start to increase and do so regularly, month by month, rather like the way that tapering was implemented with steady month by month reductions until it is expected to end in October. We cannot be sure how markets will react but an optimistic view would be that the experience of tapering which did not, in the end, upset markets, plus the fact that the start of the long road to normalising interest rates should reflect an economy which is heading in the right direction, would be well received by markets. On the basis that markets do not like shocks, clear signalling should be helpful. Nevertheless, we cannot rule out the possibility that the markets will be spooked when interest rates start to rise, even though it should have been discounted. It is as well to remind ourselves of these ongoing risks because there is a danger that the relative calmness of markets this year induces a false sense of security.

However, markets would be unlikely to be where they are now if there were not, at least, some grounds for optimism and one area where this is a reasonable position to take is the USA. Whilst the FOMC's deliberations and comments by Janet Yellen show that the level of unused capacity in the economy, particularly in the labour market, is still an issue staying its hand in starting to raise interest rates, the trend of the economy looks to be in the right direction. The latest central forecasts from the Federal Reserve point to a modest, but not unsatisfactory, progression in the US economy's growth path, 2.1% in 2014, 2.8% in 2015, 2.75% in 2016 and 2.4% in 2017 with a longer run rate of 2.15%. If these figures were to be correct then current interest rate levels would clearly be inappropriate. After a weak first quarter, when bad weather in January and February adversely affected economic activity causing GDP to decline at an annualised rate of 2.1%, there was a 4.2% recovery in the second quarter to leave the year on year growth rate at 2.5%. The purchasing managers indices, closely watched gauges of economic activity, have given strong recent readings. That for the manufacturing sector was 56.6 in September and the one for non-manufacturing stood at 58.6. These figures are lower than those for August but still quite strong. After three strong months, the index for industrial production in August showed a decline of 0.1%, retail sales, having been flat in July, rebounded by 0.6% in August. The latest Conference Board leading indicators showed a rise of 0.2% in August following a series of stronger increases than this. House prices are still rising although there is some evidence of a slowdown in the rate of increase. The S&P/Case-Shiller Composite Index for twenty cities showed a year on year increase of 6.75% in July, down from 8.07% in June. The unemployment rate has fallen to 5.9% in September down from 6.1% in August. However, it is important to note that the unemployment rate can be distorted by the participation rate which fell to 62.7% in September. Non-farm payrolls increased by 245,000 in September compared with 180,000 in August. On the political front, things have become quieter after the stand offs between the House of Representatives and the President last year over the budget and debt ceiling. On the fiscal front the budget deficit is coming down providing some offset to the reduced buying power of the Federal Reserve as its tapering programme continues and will shortly be eliminated (although it will be reinvesting bond redemption proceeds). Longer term, however, the USA's public finances will worsen as entitlement costs will increase. The mid term elections in November may result in the Republicans capturing control of the Senate in addition to retaining its majority in the House of Representatives, cementing the deadlock which now exists between the executive and legislature. From an investor's point of view, that may not be a bad thing because it may reduce the political distractions for investors as the economy moves forward. Sometimes the less governments do, the better it is for investors. Whilst the US has economic concerns, like every other country, its position appears quite good and, for international investors, it appears a relatively safe haven. For the current year, the estimated price/earnings ratio on the S&P 500 Index is around

16.0, falling to around 14.1 for 2015 earnings. As we have indicated before, it is important that US corporate earnings rise to validate the sharp increase in US share prices in 2013. As the fall in the prospective price/earnings ratio for next year, compared with the estimate for this year shows, quite a strong earnings increase is expected next year, well over 10%. Earnings have been boosted by large share buybacks as companies have used their strong balance sheets and the ability to borrow cheaply to reduce their share count. This cannot go on indefinitely and institutional investors are beginning to call for more investment. Revenue growth has lagged behind earnings per share growth and it appears that investment analysts are expecting an improvement in profit margins which are already at high levels. So, some quite bullish assumptions are being made. Despite its rise, Wall Street does not obviously look expensive, but it does need developments to remain favourable. In its favour is that it is a market that appears to have less risk than others as its economy, as far as we can see at the moment, looks reasonably predictable.

We have touched upon the eurozone in some detail earlier on in this review but it is worth discussing further. It is difficult to overstate how serious the situation has become. At the heart of the problem is the absence of any indication that growth rates in the eurozone will recover to anything like the levels necessary to provide the drivers of an improvement in the budget deficits and outstanding public debt to GDP levels in the countries in trouble. The two main concerns are France and Italy, the second and third largest eurozone economies, where economic pessimism is high and there seems to be no appetite for the growth enhancing reforms which are so vital to providing the background for economic recovery. With interest rates so low, monetary policy loses its power to affect an economy and we doubt that any further measures which the ECB may try will have a major effect. The ECB has been emphasising the need for structural reforms to encourage growth and even, perhaps, looser fiscal policy but without structural reform, particularly in the employment market, it is difficult to believe that companies will find it attractive to expand their operations. “Animal spirits” are unlikely to be aroused. The French and Italian governments are making moves to introduce limited supply side reforms but even these are meeting resistance. At some stage, if debt continues to grow in certain eurozone countries, buyers of government bonds will draw back. That is what could trigger an existential crisis for the euro.

On the policy front, the ECB went a further step towards trying to stimulate the eurozone economy. At its September meeting, it lowered its main financing rate to 0.05% from 0.15% and increased the negative interest rate for deposits parked with it by banks to -0.2%. It announced that it would start to buy asset backed securities in October although this is highly controversial, particularly in Germany. Whilst the purchase of asset backed securities might free up banks’ balance sheets and enable them to lend more, the demand has to be there in the first place and, for that to happen, there has to be economic confidence amongst would be borrowers. Equally, banks have to feel confident that lending propositions are sound. Bad debts can be far more expensive than negative interest rates. In a sign that demand for bank loans, however cheap, is not strong, the ECB allotted €82.6 billion in its first targeted longer term financing operation (TLTRO). This amount was less than had been expected. This was the first of eight TLTROs with the next one being in December.

The news coming out of the eurozone supports the flat GDP data for the second quarter. The latest eurozone purchasing managers’ composite index reading at 52.0 suggests slight growth. Within that figure, the reading for the services sector was 52.4, for manufacturing 50.3 and for construction 43.0. Looking at the four largest eurozone economies’ industrial production figures, as another gauge of activity, there was a recovery in activity in Germany in July with the month on month increase of 1.9% to give a year on year increase of 2.5%. The figures for Spain are encouraging, albeit from a low level with the month on month increase being 6.4% and the year on year increase being 1.0%. Symptomatic of the problems of France and Italy is the year on year industrial production data showing, in the case of France, an increase of just 0.1% and, in the case of Italy, a 1.9% decline. These are troubling figures for the eurozone and the trade stand off with Russia will cause some damage on top of an already fragile position. One gleam of light is the weakness of the euro which should help competitiveness if it is maintained. However, a weak euro does not change the relative competitiveness of countries against each other within the eurozone. What is needed is for the uncompetitive countries is a change in currency values against those of more competitive eurozone countries and this cannot, of course, happen within a currency union. So far, Germany has sailed through the recession relatively well but cracks are beginning to appear and the economy seems to be weakening. The Russian sanctions are a problem for Germany but, even before the elevated level of the Ukraine crisis, some warning signs were appearing. The decline in second quarter GDP of 0.2%, worse than France (0.0%) and the same as Italy, was a shock and compared with the first quarter's growth of 0.7%. The ZEW economic sentiment index for Germany fell to 6.9 in September compared with 8.6 in August and a high this year of 62.0 in January. German business confidence fell in September to its lowest level in more than a year. The lead indicator in Germany's Ifo survey fell to 104.7 in September compared with 106.3 in August which was the lowest level since April 2013. It is not easy to say anything optimistic about the eurozone as an economic area but it is different for some of their world class companies with a global reach and, in our investment policy, we distinguish between the sovereign and companies based within the area which have the possibilities of detaching themselves from the problems of their own country.

For Mr Abe, the Japanese Prime Minister, the questions are piling up over Abenomics. The revision to second quarter GDP figures showing the growth rate to have been -1.8% for an annualised quarter on quarter decline of 7.1%, has raised the question about the wisdom of increasing the consumption tax rate from 5% to 8% on the 1st April and possibly a second increase to 10% in October 2015 if sanctioned by the government. It was always going to be a delicate decision, balancing the need to start to address Japan's very serious debt position with the need to avoid unnecessary economic shocks. Mr Abe plans to make a final decision in December after the third quarter's economic data is available. Obviously, the data for the second quarter has increased the pressure on the government to defer the tax increase and some influential business leaders have backed this stance. However, with such poor debt dynamics, Japan cannot indefinitely continue to run large budget deficits and expand its ratio of outstanding public debt to GDP, currently nearly 230% of GDP, without there being some reaction in markets. Japan's latest purchasing managers indices show an economy which is finely balanced between growth and contraction. The composite index for August stood at 52.8, with the manufacturing component at 51.7 and the services component at 52.5. Industrial production in August fell by 1.5% following a poor run of figures after the consumption tax increase in April, the previous figures being -2.8% for April, +0.7% for May, -3.4% for June and +0.4% for July. As we move away from the second quarter, the data should start to settle down and a better picture should emerge about the state of the economy. The latest year on year consumer price index to August, boosted by the consumption tax increase, shows a rise of 3.3% (3.1% for the core inflation rate) and, whilst the government has been urging companies to increase wages, this has happened in only a limited way. In July, average monthly earnings rose by 2.6% year on year, below the inflation rate. Japanese consumer confidence is still fragile. Although the index has recovered from a low of 37.0 in May, at 41.2 it is almost exactly at the level it was last January. The hope was that the monetary and fiscal stimulus would overcome the effects of the consumption tax increase, but this has not so far happened. Whilst Japanese companies' profits are high, much of this is due to the strength of their overseas businesses and is not percolating through to the real economy. Japan is a country facing enormous demographic problems. This need for significant supply side reforms to increase the efficiency of the economy is more important than ever as a shortage of suitable employees becomes more acute. Japanese employers are still finding shortages and, here, market forces may play their part in driving up wages as the government would like. Surprisingly little attention is given to the level of Japanese public debt, probably because the central bank can print its own money, while those of the troubled eurozone countries cannot, and also because the vast majority of government debt is held internally. One danger which would further threaten Japanese debt dynamics is if interest rates started to rise thereby increasing the servicing costs of the national debt. What investors in Japan will want to see is evidence that the second quarter's economic weakness will start to be reversed in the third and fourth quarters and the government's and central bank's reaction if the assessment of third quarter data and beyond suggests that the recovery is disappointing. The reaction to this is likely to be a postponement of the second phase of the consumption tax rise in October 2015, a policy not without risks given the fiscal situation. From an investor's point of view, one of the attractions of Japanese shares relative to government bonds is the significant yield advantage which they carry. The estimated yield on the Nikkei 225 for this year of approximately 1.6% compares favourably with that on a ten year JGB of 0.53% and Japanese dividends are rising, being about a fifth higher in yen terms compared with 2013. The rewards for setting economic policy on the right path will be great but, as we have outlined above, there were major potential problems. Boldness in implementing the third arrow of Mr Abe's reforms, the structural one, would be an important positive step although, like nearly all reforming politicians these days, he will face major vested interests and his boldness, or otherwise, in facing up to them will define his success or failure. So, Japan is a high risk/high reward market worthy of modest exposure and, as the world's third largest economy, should not be ignored.

If Japan is at a crossroads, China is also as it undertakes a transformation of its economy towards one based more on consumption and less on fixed asset investment. This involves a slowdown in the economy's growth rate from the double digit level seen a few years ago to one somewhere around 7.5%, if that can be achieved, and remain consistent with maintaining social cohesion. With property prices falling in many parts of the country, concern about bailing out bad debts is growing although China is a country which can probably handle this problem better than most. Average new home prices in China fell by 1.1% in August compared with July to give the fourth consecutive month of declines. The size of the Chinese economy means that international investors' attention is focused on important data releases which can influence international stock markets on a day to day basis. Second quarter GDP rose by 2.0% on a quarter on quarter basis to give 7.5% year on year, which is about where the authorities would like it to be although there is some nervousness amongst investors about what the rest of the year could bring. The latest purchasing managers indices for August showed a reading of 51.1 for manufacturing, slightly down on July's level of 51.7, and 54.4 for non manufacturing, slightly up on July's level of 54.2. Industrial production in August rose by just 0.2% compared with July's rise of 0.68% to give a year on year increase of 6.9%, down from 9.0%. It was speculated in the press in mid September that the People's Bank of China had given a short term stimulus to the economy to the tune of the equivalent of £50 billion of liquidity (500 billion yuan). Commodities are sensitive to the activity levels in the Chinese economy and a fall in the price of iron ore is symptomatic of the effect which the downgrading of fixed asset investment relative to consumption is having internationally. China remains an important driver of international securities' markets. From a political standpoint, all eyes will be on China as to how it handles the increasing unrest in Hong Kong.

For the UK, September has been a momentous month because of the Scottish independence referendum. Until very recently, it has received little attention from investors because a "no" vote was discounted as very few people believed that there would be a "yes" vote. Only when the opinion polls narrowed and one put the "yes" campaign ahead close to the referendum, did markets take notice and sterling begin to react to what would, economically, have been an extraordinarily destabilising position. In the short term, at least, the referendum probably caused some economic damage to the UK as investment was deferred and other economic activity curtailed. Investors in the UK markets now have to consider the next major political issue, next May's General Election. In this respect, the opinion polls have been quite stable for a long time and suggest a change of government, especially with the proposed boundary changes having been voted down in parliament. Investors in the UK stock market therefore have to consider the investment implications arising from a change of government. The forthcoming election is particularly important because a large policy divide has opened up between the two main parties. Should there be a change of government, on announcements so far, there are policies which would have a particular effect on certain sectors, notably energy, banking, railways, housebuilders, gaming companies and tobacco companies. The property market could also be affected by rent controls and capital taxes on certain properties. The policy background is likely to be a difficult one for businesses, or at least for certain sectors, and this is likely to reduce the attractions of the UK stock market relative to certain others. It is an issue we will be considering in the run up to the General Election if there is no meaningful movement in the opinion polls. There can be no complacency about the UK's economic position. Even though the UK is the G7's best performing economy, it is still hugely indebted and years of hard graft on debt reduction lie ahead for whichever government is in power after next May's General Election. It is therefore vital that economic policies are in place which encourage economic growth, for it is that which is essential to a successful policy for addressing the deficit just as it is in the eurozone. For the UK to remain an attractive stock market, this condition has to be in place. The seriousness of the UK public debt levels cannot be overstated. With the UK economy performing well relative to those of other G7 countries, the issue has gone off some people's radar but it will soon return if there is a loss of foreign confidence in the UK.

Most of the economic data from the UK has been encouraging and stands in contrast to the dire economic news from the eurozone. But, of course, the two areas cannot be isolated. A weak eurozone means that UK exports to the area suffer and the effects of the sanctions tit for tat with Russia, which directly affect eurozone economies more than the UK, will filter through to the UK. So it would be wise to expect some slowing down in the good economic news from the UK. In the paragraph above, we mentioned how much work there was still to do in addressing the UK's public finances' problem. Even though the UK economy is performing well, the figures for the UK's public finances are still very poor. In August, the government had to borrow £11.6 billion which was an increase of £700 million on a year ago. For the first five months of the current fiscal year, borrowing is 6.2% higher than a year ago at £45 billion. There are some special factors at work which could mean that they are not indicative of the full year's outcome. It is tax receipts which are the problem so far this year but there is reason to believe that they can pick up later this fiscal year. However, the point is that, even with the economy performing strongly, public finances remain very difficult to control. If, for any reason, growth slows down significantly, then the problem will become worse. The UK has no room for complacency about its public finances, as we say above, and it could be vulnerable to external shocks, so whichever government is in office is going to have to give full attention to improving the UK's public finances.

However, there has been plenty of good news for the UK to set against the worries about its public finances. The second quarter showed quarter on quarter GDP growth of 0.6% and year on year growth of 3.2%. Unemployment has continued its downward trend, now standing at 6.2%, still too high but, compared with the eurozone's level of 11.5%, a sign of a more healthy economy. The important purchasing managers indices have been very strong. The composite index for August stood at 57.4 with that for manufacturing at 51.6, for services at 58.7 and for construction at 64.2.

The overall level, despite a slight slowdown from August, implies quite strong economic growth, whilst production in July showed a 0.5% increase over June for a year on year increase of 1.7%, both figures being better than the respective ones for June. One of the areas of concern has been the housing market, where rapidly rising prices have raised concerns and caused the use of a macroprudential tool to try to ensure that a housing bubble does not emerge, although some would say that we are already there. The latest Land Registry figures show that house prices in England and Wales rose by 1% in August compared with July to give a year on year increase of 8.4%, the highest rate of increase for nearly seven years. Other measures of house prices have shown higher increases but there is evidence that house prices have stabilised or fallen in London after the strong increases in recent years. The UK market is likely to be increasingly influenced by politics in the run up to next May's General Election as the policy differences between the two main parties are so wide. Foreign investors are likely to be increasingly sensitive to developments in the UK.

In recent reviews, we have suggested that international equity markets would grind higher this year with some setbacks along the way, implying one or two negative quarters, and it is possible that the final quarter of 2014 will be one such, having had a difficult start, although it is, of course, early days. Politically and economically, especially in the eurozone in the latter's case, the background remains difficult, but there should be sufficient economic growth to drive corporate earnings higher in many countries. For the reasons given in this review, we believe that equities remain the most attractive asset class, although we do expect relatively modest returns with some difficult moments along the way. As before, where we have been building up cash in portfolios which are fairly fully invested, we are looking for any meaningful market setbacks to commit more cash to the market.