



**meridian**

ASSET MANAGEMENT (C.I.) LIMITED



## Investment Memorandum

More stable conditions in markets recently suggest some lessening of concerns about the health of the financial sector. Decisive action by central banks and individual financial institutions' fund raising, where required, have contributed to this slightly better situation which has been reflected in a generally satisfactory quarter for stock markets.

The tables below detail relevant movements in markets :

### International Equities 31.01.08 - 30.04.08

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+0.3	+6.3	+5.9	+0.7
Finland	-9.3	-4.3	-4.6	-9.3
France	+4.0	+9.8	+9.4	+4.0
Germany	+2.2	+7.9	+7.5	+2.2
Hong Kong, China	+3.8	+4.2	+3.8	-1.3
Italy	-1.3	+4.1	+3.8	-1.3
Japan	+2.0	+4.2	+3.8	-1.3
Netherlands	+6.3	+12.2	+11.8	+6.3
Spain	+4.9	+10.7	+10.3	+4.9
Switzerland	+0.5	+5.0	+4.6	-0.5
UK	+5.2	+5.2	+4.8	-0.3
USA	+0.9	+1.3	+0.9	-4.0
Europe ex UK	+2.8	+8.5	+8.1	+2.8
Asia Pacific ex Japan	+6.5	+9.0	+8.5	+3.2
Asia Pacific	+4.2	+6.5	+6.1	+0.9
Latin America	+10.7	+15.3	+14.8	+9.2
All World All Emerging	+8.8	+10.1	+9.7	+4.3
The World	+2.9	+4.8	+4.4	-0.7

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : -.05%

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

Currency	31.01.08	30.04.08
Sterling	4.53	4.67
US Dollar	3.64	3.75
Yen	1.45	1.63
Germany (Euro)	3.93	4.12



### **Sterling's performance during the quarter ending 30.04.08 (%)**

<b>Currency</b>	<b>Quarter Ending 30.04.08</b>
US Dollar	-0.3
Canadian Dollar	-0.5
Yen	-2.1
Euro	-5.3
Swiss Franc	-4.3

### **Other currency movements during the quarter ending 30.04.08 (%)**

<b>Other Currency</b>	<b>Quarter Ending 30.04.08</b>
US Dollar/Canadian Dollar	-0.1
US Dollar/Yen	-1.7
US Dollar/Euro	-4.9
Swiss Franc/Euro	-1.0
Euro/Yen	+3.4

### **Significant Commodities (US dollar terms) 31.01.08 – 30.04.08(%)**

<b>Significant Commodities</b>	<b>31.01.08 – 30.04.08</b>
Oil	+21.3
Gold	-5.7

### **Markets**

Although there has been a significant level of volatility, particularly in the earlier part of the quarter, the overall result for international equity markets must be considered satisfactory. The movements in the FTSE World Index have not been significant and suggest a degree of resilience in equity markets. The total return on the FTSE World Index in local currency terms was 2.9%, in sterling terms 4.8%, in US dollar terms 4.4% and in Euro terms -0.7%. Of the major markets, the UK performed best in local currency terms, showing a return of 5.2%. Europe ex UK returned 2.8%, Japan 2.0% and the USA 0.9%. As so often in recent times, Asia Pacific ex Japan, Latin America and emerging markets showed the best performances with the relevant indices returning 6.5%, 10.7% and 8.8% respectively. With sterling being weaker against all major currencies during the quarter, the order of returns changes. Of the major areas, sterling investors saw the best returns from Europe ex UK where the return was 8.5%. Japan returned 4.2% and the USA 1.3%. Returns from Asia Pacific ex Japan, Latin America and emerging markets all saw enhanced returns in sterling with figures of 9.0%, 15.3% and 10.1% respectively.

As a result of weakness in top quality international bond markets towards the end of the period, bond yields, as measured by those on ten year government bonds, trended higher. Those on sterling bonds rose by 14 basis points to 4.67%, those on US dollar bonds by 11 basis points to 3.75%, those on yen bonds by 18 basis points to 1.63% and those on German government Euro denominated bonds by 19 basis points to 4.12%. We will discuss this weakness shortly but believe that a slightly lower level of risk aversion amongst investors and rising concerns about inflation could be contributing factors.

Sterling continued its weakness over the quarter falling particularly sharply against the Euro (5.3%) and the Swiss franc (4.3%).

In commodity markets, oil continued to be a feature, rising by 21.3%, but gold fell back by 5.7%.



## Economics

- *Equity markets regain some composure.....* the converse of this is that high quality bonds have weakened as investors, at least temporarily, become less risk averse.
- *Central banks act to try to free up money markets.....* the central banks use unorthodox methods to provide more liquidity for markets.
- *However, there is stress in money markets.....* inter bank rates remain well above levels one would expect in normal circumstances relative to official rates.
- *The Federal Reserve remains by far the most aggressive central bank.....* not only does it act to try to free up money markets, it cuts rates aggressively and the Federal Funds rate now stands at 2%, 3.25% below its peak last year.
- *The IMF cuts its forecast for economic growth.....* it now expects the major advanced economies to grow by 0.9% this year and next but China and India are expected to continue to grow strongly at 9.3% and 7.9% respectively, below last year's level but still fast.
- *It is reasonably sanguine about inflation.....* it expects the major advanced economies to experience 2.4% inflation this year, falling to 1.8% next year.

## USA

- *The Federal Reserve cuts interest rates again.....* in cutting them to 2% on 30th April, it indicates there may be a pause before any further reductions.
- *Tax cuts are now coming through.....* individual tax payers will receive tax cuts now and the hope is that this will boost the economy. Two thirds of the overall tax cut is going to consumers.
- *The US stock market performs relatively well.....* perhaps investors are anticipating economic recovery following the fiscal and monetary stimulus.
- *The housing market remains a problem.....* the figures show housing starts and prices continue to be weak. Falling house prices create a negative wealth effect.
- *The Federal Reserve may now concentrate more on inflation.....* having cut interest rates so aggressively so that the official rate indicates negative real rates, it may be reluctant to act again in the near term. Year on year PPI inflation is 6.9% and headline CPI is 4.0% with respective core rates at 2.7% and 2.4%.
- *Inflation expectations are rising.....* the University of Michigan's index shows long term expectations up to 3.2% in April.
- *Excluding financials, corporate earnings hold up well in the USA.....* many US companies are benefiting from the lower dollar and exposure to faster growing areas of the world economy such as emerging markets.

## Japan

- *The opposition's control of the Upper House is causing political problems.....* it delayed the appointment of a new Governor of the Bank of Japan and caused a temporary reduction in petrol tax to the detriment of government revenues.
- *As expected, the Bank of Japan has kept interest rates unchanged at 0.5%.....* it reduces its forecast for economic growth in the year to March 2009 to 1.5% compared to 2.1% previously with inflation of 1.1%.



- *The OECD has strong recommendations for Japan.....* it is concerned about the state of government finances both in relation to the budget deficit and the ratio of gross public debt to GDP. It recommends increasing the sales tax and extending the base of taxation.
- *The latest Tankan survey shows a deterioration in business sentiment.....* large Japanese manufacturers are less confident than they were and plan to cut back capital spending more sharply than at any time since 2002.
- *However, Japan remains well placed to benefit from fast Asian growth and from China in particular.....* the profile of its exports is beneficial in this respect.

## **Europe Ex UK**

- *Although the area has held up relatively well, there are signs of a slow down.....* the EC reduces its forecasts for the EU and Eurozone for this year and next compared with its last forecast.
- *Inflation remains worryingly high for the ECB.....* although the provisional estimate for Eurozone inflation in April is 3.3%, lower than expected, it is still well over the top end of the ECB's target range, just below 2.0%.
- *Inflation causes the ECB to be very cautious on interest rates.....* with inflation so well above its target, it sees little room to cut interest rates and is worried about higher wage deals, particularly in Germany.
- *The "one size fits all" interest rate is causing a problem.....* there are divergent performances amongst Eurozone countries and Spain and Ireland, in particular, could benefit from lower interest rates as a result of weakness in their housing market.
- *Progress has been made in reducing budget deficits.....* the EC says that Eurozone government deficits collectively more than halved in 2006 to 0.6% of GDP from 1.3% in 2006.
- *There is some cause for concern about Germany.....* with elections approaching, populist economic policies are being announced which causes concern amongst economists. Large wage increases and the reversal of economic reforms are worries for economists.
- *In France, President Sarkozy announces measures to reduce the budget deficit to zero by 2012.....* there is a good deal of scepticism that he will be able to do this with the balanced budget promise already having been put back by two years to 2012.

## **United Kingdom**

- *Economic conditions are becoming more difficult.....* the slide in sterling gives some indication of changing perceptions about the UK.
- *The housing market is starting to turn down.....* the implications could be unpleasant, as a result of a negative wealth effect.
- *Stretched public finances give no room for reflation in the face of a turndown.....* embarrassingly for the government, the EU is to start an excessive deficit enquiry into the UK's public finances.
- *The Treasury looks for new and increasing sources of revenue.....* but this action, not usually recommended in the fact of an economic downturn, could backfire.
- *The Treasury's forecast for public borrowing looks too optimistic.....* it has consistently underestimated the level of government borrowing and its economic forecasts seem far more optimistic than those of most independent observers, thus threatening further deterioration in the budget deficit.



- *Interest rates remain unchanged at 5% in May, having been reduced in April.....* but the MPC was split over the April decision with the majority voting for the 0.25% cut, one for a 0.5% cut and two voting for no change. It remains concerned about inflation.
- *Growth is slowing down.....* GDP growth was 0.4% in the first quarter of 2008 compared with 0.6% in the last quarter of 2007 with annual growth falling from 2.8% to 2.5%.

## China

- *First quarter growth was 10.6% annualised.....* this was faster than expected.
- *The Chinese authorities remain very concerned about inflation.....* it runs at an annual rate of 8.3% in March, propelled by food prices which account for 6.8% of the rise in the first quarter.
- *China raises bank reserve requirements again.....* this time by another 0.5% to 16%.

## Summary

- *No one should underestimate the financial problems at present.....* they will cause growth to slow down.
- *But conditions in the stock market suggest investors are slightly more confident.....* equity markets appear to be less volatile and have performed relatively satisfactorily this quarter.
- *We believe that investors should be concentrating on the measures to boost growth.....* particularly in the USA aggressive monetary easing and fiscal reflation should start to benefit the economy later this year.
- *Shares are not highly rated.....* many companies are still producing good profits and balance sheets are generally strong outside the financial sector.
- *In our view, bonds remain unattractive.....* yields are simply not high enough to accommodate present and possibly rising inflation rates on the back of higher food and energy prices.

In recent weeks, stock markets have appeared to regain some degree of confidence and shares have started to move higher after a poor performance in the first quarter of the year. Conversely, bonds have shown weakness recently as investor confidence shows some recovery and investors become slightly less risk averse and more concerned about inflation. Whilst it is too early to say whether a trend has been established, we think this change in direction in equity and bond prices is logical.

Why would we say this when we constantly read about this bank or that having to make further write-downs or write-offs, almost, it seems, on a daily basis? We also read about continuing inflation in energy and food prices and concerns about food riots in some countries. Economic growth forecasts are being lowered in most countries. Previously favoured sectors like property have fallen out of favour. High quality international equities seem to us to be the asset class most suitable to the present environment. Why should this be so?

Firstly, perhaps, we should look at the attractions or otherwise of other asset classes. Gross redemption yields on ten year government bonds at the end of April are as shown on the table at the beginning of this review - i.e. 3.75% for US government bonds, 4.67% for UK government bonds and 4.12% for German Euro denominated government bonds. In times of stress, top quality issues, such as these, attract funds on a safe haven basis but, on



an objective assessment, investment attractions are difficult to find. If we take the latest forecast for consumer prices in 2008 made by the IMF in its World Economic Outlook, we see an estimate of 3.0% for the USA, 2.8% for the Eurozone and 2.5% for the UK. Real returns are, therefore, low and, prima facie, not attractive. They still could be, however, if there was a realistic expectation of a sharp fall in inflation such that real returns would be much higher at these yields but that does not look a realistic expectation with the profile of the cost push inflation that currently exists. The real returns which government bonds are currently offering are much lower than one would expect to be seeing in the medium and long term from equities. Cash, as an investment, is not a long term option for any but the most cautious of investors who are prepared to accept a decline in the real value of their capital each year. It gives flexibility to be able to invest at a time of an investor's choosing so that entry into the investment market can be finessed. But real returns are currently low or negative if one uses the central banks' official rates as benchmarks. Property has been a popular asset class but has developed bubble characteristics in certain areas, helped by the availability of cheap finance. Now that the world economy is slowing down, demand is being curtailed, threatening rental yields, and the availability of finance is becoming more limited. Certain open ended property funds have become forced sellers of property assets to meet redemptions. Whilst most western economies are in a fragile state, it is difficult to see property repeating the performance of recent years. Whilst these comments relate to commercial property, the housing market in the USA, as everyone knows, has shown marked weakness (the sub-prime mortgage market is at the root of current financial markets' problems) and the UK housing market is turning down.

Against this background, the international equity market can be said to have held up relatively well. In 2007, the FTSE World Index, in local currency total return terms, returned 6.9% and that included the period when the sub-prime mortgage problems began to surface. For the first four months of this year the return has been -5.8%. For sterling investors, the situation has been mitigated, to some extent, by the currency's weakness so that the return for the first four months of the year of -3.2% would probably be viewed as quite a favourable result, given all the negative headlines. There have, of course, been widely diverging performances between different stocks and sectors, with financials being particularly hard hit, but every asset has a price and we have argued for a long time that shares do not look expensive. For the USA, the current year estimate is for a P/E of about 15 on the S&P 500. For most major European markets, prospective P/E ratios for this year are around 11 and not much higher for the UK. Dividend yields compare favourably with bond yields almost everywhere. Bears argue that earnings reflect peak levels and that, cyclically adjusted, shares do not look as cheap as they appear. But, granted that this year and probably next year will be difficult for many companies, it is difficult to predict a collapse in earnings overall. Obviously, financials are going through a very difficult time but, as the US earnings season shows, many companies are still performing satisfactorily. Earnings yields, the reciprocal of the price/earnings ratio, stand considerably above bond yields and our broad view is that the current rating of shares takes care of the uncertainties which exist in the world economy. We do not, in any way, underestimate the problems in the world economy but we believe that the general level of share prices takes care of this.

Estimates of the potential losses in the financial sector are naturally very difficult to make but, in April, the IMF gave its view of the magnitude of the problem. Its estimate of the possible losses and write downs was US\$945 billion. This covers a range of financial institutions, not only banks but also pension funds, insurance companies, government sponsored enterprises and hedge funds. The IMF estimates that nearly half of the losses and write downs will be taken by non-bank financial institutions. The IMF estimates that the losses and write downs will amount to about 7% of US GDP. The losses and write downs will be spread around. It estimates that European banks' exposure will be around US\$120 billion against about US\$140 billion by US banks. We have seen US, UK and European banks take measures to repair their balance sheets through rights issues, capital subscribed by sovereign wealth funds and asset sales. Money has also been saved through dividend cuts or by dividends being paid in shares only.



We will look at the IMF's latest economic forecasts shortly and, naturally, that shows lowered expectations compared with earlier forecasts. We will look at the transmission mechanism by which this has happened and by products of the situation. Lack of trust amongst the banks has led to a hoarding of cash. This also has been due to possible calls on cash, for instance from conduits which have to be taken on their balance sheets. The extreme tension in money markets has seen interbank rates move well above base rates. Therefore, the availability and cost of money are factors slowing down economic growth or, in some cases, possibly causing it to contract. Lower economic growth will cause unemployment to rise and falling house prices will create a negative wealth effect. Whilst various influences can cause an economic slow down or recession, this present situation is aggravated by the seizing of up of the money markets. So, central banks, as well as controlling monetary policy, now have to act in variations of lender of the last resort role. This, the central banks of the USA, UK and Eurozone have done through various innovative measures. It is still early days but, as this is written, the gap between official rates and one, three, six and twelve months rates still shows every sign of stress in the US, UK and Eurozone money markets.

These events are making policy making very difficult. As far as monetary policy is concerned, the effect of reductions in official rates is muted by the reluctance of money market rates to reflect fully the cut. So, for example, house borrowers in the UK are, in some cases, facing rising borrowing costs even though official rates have fallen. For monetary policy to work, confidence must return to money markets. But the cost push inflation to which we referred earlier is complicating matters further. The publicity given to rising energy and food prices is making people aware of the difference between core inflation and headline inflation rates. With the difference between the two measures usually reflecting the absence of food and energy costs in the core rate, it is becoming increasingly difficult to justify using the core rate as a useful measure of inflation. Headline rates of inflation are much more likely to reflect the fact that food and energy costs are now making their influence felt in the general price level. That being the case, people will be looking for their pay to reflect what they perceive to be the more realistic level of inflation rather than a rate which is temporarily expanded by rising food and energy costs. If monetary policy worked properly in that lower official rates brought down the general level of short term interest rates, policy makers would be concerned about the danger of interest rates being set too low for the current inflation level, a situation which could send inflation higher.

The Federal Reserve has no such dilemma. It can look at the whole economic picture, of which inflation is only one element, and feel less uncomfortable about reducing interest rates as aggressively as it has. It can and does mention its concern about inflation but it is also influenced by economic growth prospects and the housing market, to name two obvious issues at present. For the ECB and Bank of England, worried that inflation is above official target levels, the constraints on cutting interest rates are obvious, yet if they were to be taking into account growth prospects they might start to cut interest rates in the case of the ECB or cut them more aggressively in the case of the Bank of England.





Against this rather difficult background for policy makers, it is helpful to look at certain forecasts from the IMF's latest World Economic Outlook published in April.

### Real GDP Growth (%)

Country	2007 (actual)	2008 (estimate)	2009 (estimate)
USA	+2.2	+0.5	+0.6
Eurozone	+2.6	+1.4	+1.2
Germany	+2.5	+1.4	+1.0
France	+1.9	+1.4	+1.2
Japan	+2.1	+1.4	+1.5
UK	+3.1	+1.6	+1.6
Major advanced economies	+2.2	+0.9	+0.9
Newly industrialised Asian economies	+5.6	+4.0	+4.4
China	+11.4	+9.3	+9.5
India	+9.2	+7.9	+8.0

### Consumer Prices (%)

Country	2007 (actual)	2008 (estimate)	2009 (estimate)
USA	+2.9	+3.0	+2.0
Eurozone	+2.1	+2.8	+1.9
Germany	+2.3	+2.5	+1.6
France	+1.6	+2.5	+1.7
Japan	—	+0.6	+1.3
UK	+2.3	+2.5	+2.1
Major advanced economies	+2.2	+2.4	+1.8
Newly industrialised Asian economies	+2.2	+3.0	+2.7
China	+4.8	+5.9	+3.6
India	+6.4	+5.2	+4.0

Source IMF World Economic Outlook

We turn now to look at each major area of the world economy, starting with the USA. Here, the US Federal Reserve at its meeting on 30 April reduced interest rates by a further 0.25% to 2%. It has indicated that there may be a pause before any further reductions, but the policy of reducing interest rates from their peak of 5.25% in 2007 has been nothing if not aggressive. This latest move will coincide with the cheques coming through for individual tax payers as a result of the fiscal reflation measures announced by the Administration earlier on and, together, this monetary and fiscal stimulus can be expected to have some beneficial effect on the economy later



this year. The big question for consumers who will benefit from two thirds of the tax cut is whether it will be used to spend, if so, on what type of goods, or whether it will be used to reduce debt or, more likely, a combination of the two. The action by the US authorities, both monetary and fiscal, is by far the most aggressive taken anywhere in the world to meet the current circumstances. It is interesting to note that the US stock market has held up relatively well this year and it may well be that investors are anticipating an improvement in the economy towards the end of the year. To us, this seems sound thinking. But things will not get better overnight and the majority of the current information coming out of the US economy, and this will probably be the same for the next few months, shows continued weakness.

The ISM's index of overall activity in US industry remained unchanged at 48.6 in April. At least the situation was not getting any worse. Factory orders in February fell by 1.3%, the second fall in a row. The ISM index for the services sector rose slightly in March to 49.6 from 49.3 in February, approaching the level when an improvement in the economy is indicated. Although negative, the latest US employment figures, announced at the beginning of May, were better than expected. 20,000 jobs were lost in April compared with 81,000 in March. Consumer confidence remains low. The University of Michigan's consumer sentiment index fell to 62.6 in April compared with 69.5 in March. The Conference Board's measure of US consumer confidence fell to 62.3 in April compared with 65.9 in March. This is the lowest reading for over five years. Durable goods orders continued to fall in the USA. In March, they fell by 0.3%, having fallen by 0.9% in February. However, the new orders, excluding transportation, rose by 1.5% in the month. But orders for motor vehicles were down by 4.6%, a weaker figure than the 3.2% fall in February.

However, there were some brighter spots amongst the figures. Headline retail sales in March were up by 0.2%, a better result than expected. In the manufacturing sector, the New York Federal Reserve's Empire State manufacturing index showed a reading in April of 0.63 compared with a record low in March of -22.23. Industrial production rose in March by 0.3% following a fall of 0.7% in February. Consumer spending was higher than expected in March with a rise of 0.4%.

In a sense, however, these figures are secondary compared with the situation in the housing market, the original cause of most of the current economic and financial problems. By now, one had hoped for an improvement in the data, but these hopes have been dashed and we now need to look towards later this year for an improvement. The monetary and fiscal stimulus should help but equilibrium has to be restored to the market and the housing overhang reduced to manageable levels. The National Association of Realtors' index of pending sales of existing US homes showed a fall in the index to 84.6 in February compared with 86.2 in January. One year earlier, in February 2007, the index had stood at 107.6. The latest figure is the lowest since records started in 2001. Housing starts fell sharply in March by 11.9% to the lowest level for seventeen years. New construction of single family homes fell, in March, by 5.7%, the lowest rate since January 1991. The National Association of Realtors reported that sales of existing American homes fell 2% during March. New homes sales fell to a seventeen year low in March. They were down by 8.5% and February's figure was also revised downwards. The figure was 36.6% below that of a year previously. According to the latest Standard & Poors/Case Shiller 10-city index of family house prices, they contracted by 13.6% year on year which was the most since their records began in 1987. The larger 20-city sample fell by 12.7% compared with a year earlier and this was the biggest drop since the index's inception in 2001. So, not really much joy on the housing front so far. Falling house prices cause a negative wealth effect and the monetary and fiscal stimulus is in place to try to reverse this situation and produce a better result for the economy later this year.



However, although the Federal Reserve appears to be concentrating more on the down side risks to the economy, inflation, which was uppermost in its mind, until recently, still has to be watched very closely and the current very low federal funds rate must be predicated on expectations of better inflation prospects since the federal funds rate implies a negative real rate of interest. This can be justified in exceptional circumstances but does run the risk of building up inflationary pressures in the economy. There is still pressure on wholesale prices. In March, they rose by 1.1% at the headline rate whilst the core rate, which excludes energy and food, rose by 0.2%. Year on year headline PPI inflation rate was 6.9% and the core rate was 2.7%. At the consumer level, the headline consumer price index rose by 0.3% in March to give a year on year increase of 4.0% compared with that for the core CPI of 2.4%. Slightly disturbingly for the Federal Reserve, long term inflation expectations, as measured by the University of Michigan, rose to 3.2% in April. Like the Bank of England, the authorities watch inflationary expectations because they help to determine interest rate policy and there is evidence that the core rate of inflation is losing credibility with people. The IMF is fairly gloomy about growth prospects for the USA this year and next year where it sees only a slight recovery to growth of 0.6% compared with that for advanced economies generally of 1.3%. A lot will depend upon the extent to which the monetary and fiscal stimulus works for the US economy. Meanwhile, excluding financials, corporate earnings growth has been quite good in the USA in the first quarter. Many US companies benefit from their overseas exposure where currency factors are favourable and also they reach deeply into emerging markets where growth rates are faster. Good quality international US companies remain a fairly safe way of benefiting from emerging markets growth without taking excessive risk. Furthermore, one detects signs of a more constructive attitude to the US dollar. The prospects of some economic recovery later this year and a current account improvement, as the benefits of a more competitive currency become apparent, could well attract more foreign interest in the US stock market which has shown relative out-performance this year and looks reasonably valued.

The Japanese stock market, often moving in a different direction to other markets, has performed roughly in line with the FTSE World Index this quarter. There has been quite a lot of news in Japan, as political difficulties caused the government problems in obtaining parliamentary approval for the new Governor of the Bank of Japan and because the opposition blocked the renewal of a “temporary” petrol tax, in place for many years, which the government said threatened to blow a hole in its finances. Inflation has started to rise in Japan, having been non-existent for a long time. The Bank of Japan, in keeping its interest rates unchanged at 0.5% and reducing its forecast for economic growth in the year to March 2009 to 1.5% compared with 2.1% previously, now forecasts inflation of 1.1%. As we have often commented in the past, deflation can be as damaging for an economy as inflation and it has certainly been a cause of Japanese economic problems over the years. In a period of deflation, because interest rates cannot fall below zero, monetary policy becomes less effective. Now, at least, there is a chance that monetary policy can become more effective for Japan. The OECD’s latest economic review on Japan is quite definite in its recommendations. It is concerned about the level of the budget deficit and the ratio of gross public debt to GDP which was about 180% in 2007. Although a large level of debt might not seem a problem when interest rates are so low, if they did rise sharply, then the servicing cost of the debt would put a further strain on the already excessive budget deficit. The OECD is recommending a significant switch from direct to indirect taxation involving a sharp rise in the sales tax and widening the tax net. Political deadlock does not make decision making any easier. The OECD has a low estimate of the potential growth rate of the Japanese economy at 1.4% and recommends measures to raise productivity towards US levels. It is well below it at present.

In terms of economic news, there has been deterioration in business sentiment in the first quarter, according to the latest Tankan survey. Its headline index fell to 11 in March from 19 in December. The survey shows that large Japanese manufacturers are less confident than they were and are planning to pare back capital spending more sharply than at any time since 2002. They are also predicting that profits will fall for the first time since Japan’s



recovery began in 2002. Large manufacturers report that they expect to cut capital spending for fiscal 2008 by 1.6% with the average of all industries showing a fall of 5.3%. In another negative reading, a government survey showed Japanese consumer confidence falling to a five year low. The country's tertiary index, measuring spending in the services sector, fell by 1.7% in February because of lower spending on financial and insurance services and property. Strong export growth has been beneficial for Japan with its important Asian trade links, including those with China, giving good support to its manufacturing industries. However, there has been some suggestion recently of slower growth because of a recovery in the yen and slackening shipments to Asia. It remains to be seen whether this is a longer term problem. The forecast, as we can see from the latest IMF World Economic Review, suggests still quite strong growth in the region. On a positive note, there was a rise of 1.6% in industrial production in Japan in February. This compared with a 2.2% fall in January. We mentioned earlier the inflation forecast for the Bank of Japan. Core consumer prices rose for the first time in ten years in March with a 0.1% year on year increase. Including energy, the rate of inflation was 1.2% which was the highest for ten years.

More countries have economic problems at the moment, but those for Japan always seem to be emphasised more. There are structural problems arising from the large budget deficit and the high level of government borrowing in relation to GDP but the economy has an excellent profile in terms of being able to benefit from continued rapid growth in Asia. This, in itself, justifies modest exposure to what is still the world's second largest economy.

The Eurozone has been quite resilient in the face of an economic downturn but, even here, the prospects have weakened. The European Commission in its latest forecast suggests that growth in the EU will slow from 2.0% in 2008 to 1.8% in 2009, and, within the Eurozone, from 1.7% in 2008 to 1.5% in 2009. This compares with earlier EC predictions, last November, of growth of 2.4% in 2008 and 2009 for the EU, and of 2.2% and 2.1% respectively for the Eurozone. Its latest inflation forecasts suggest EU inflation of 3.6% in 2008 falling to 2.4% in 2009, whilst Eurozone inflation is forecast to be 3.2% in 2008 and 2.2% in 2009. The IMF's forecasts for the Eurozone suggest growth of 1.4% this year and 1.2% in 2009. It sees inflation averaging 2.8% in 2008, falling to 1.9% in 2009.

The short term indicators from the Eurozone have been mixed. According to the latest purchasing managers survey, the headline index for the services sector fell in March to 51.6 from 52.3. The business confidence index for Belgium, widely regarded as an indicator of the experience of the Eurozone generally, saw a sharp fall in April, its biggest ever monthly drop.

In keeping interest rates unchanged at 4%, the ECB, which has a strict inflation mandate, shows its concern about inflation, notwithstanding the slow down in the world economy. The provisional estimate for Eurozone inflation in April is 3.3% compared with 3.6% in March. This is a slightly lower figure than expected but is well over the upper target limit of close to but just under 2.0%. The ECB is concerned about higher pay deals. In Germany, there is a widespread consensus that higher wage deals are justified by the restraint shown in recent years and as a way of getting consumer spending to rise. However, it is difficult to isolate the movement of wages in one Eurozone country from the others and this development will worry the ECB. At the time, in April, when interest rates were kept unchanged, Mr. Trichet, President of the ECB, warned against the danger of generous wage deals. Mr. Trichet said that the economic fundamentals of the Eurozone were "sound" and without the imbalances seen in the USA. But he emphasised the "down-side risks" relating to what was happening in financial markets. Eurozone money supply growth has been rising very rapidly and this is something about which the ECB has been concerned because of its implications for inflation. There are signs now of a slow-down in the



rapid rate of growth. The growth of M3 in March fell to 10.3% compared with 11.3% in February. Lending for house purchases is also growing more slowly with the annual rate in March at 6.1% compared with 6.6% in February. The differing performances of housing markets within the Eurozone is a problem for politicians in those countries. We are thinking here of Spain and Ireland, which enjoyed a boom, but where prices are now slipping. There is no monetary tool that the Spanish or Irish authorities can use to stabilise the situation having lost control of their ability to set interest rates when the countries joined the Euro. The problems of the Euro could come back to haunt policy makers very shortly. There are, however, signs of more fiscal discipline within the Eurozone. According to the EC, Eurozone government deficits collectively more than halved in 2007 to 0.6% of GDP from 1.3% in 2006 whilst total government debt as a percentage of GDP declined from 68.4% to 66.3%. It will be interesting to see how this discipline holds up in the more difficult economic weather now being faced.

With the elections approaching, there has been concern about the growth in populist economic policies in Germany which threatened to undo some of the policies undertaken in recent years which has helped to increase the flexibility in growth prospects of the German economy. Coalition politics have been at work and some commentators have expressed alarm at what has been happening. A panel of leading economists in Germany has said that it was “not helpful” of the government to give the green light to large wage increases and it said the government was wrong to reverse economic reforms, including cuts in benefits of older jobless people and to increase pensions this year and next. In terms of economic news, industrial output in Germany rose in February, helped by mild weather. It rose by 0.4% and the output figure for January was revised from a negative figure of 0.4% to a positive figure of 1.4%. March’s inflation figure for Germany was a pleasant surprise with the rate dropping to 2.6% from 3.3%. On the negative side, German investor sentiment declined significantly in April. It stood at -40.7 compared with -32 in March, according to the ZEW Institute’s economic sentiment indicator. The projection of leading economic think tanks is that German economic growth will “lose momentum” this year as a result of high energy and food prices, the strong Euro and turmoil in the global financial markets. The growth rate of 2.5% in 2007 is likely to fall to 1.8% this year, says the joint forecast prepared for the German government by eight economic institutes. Their previous growth forecast was 2.2% but said this was revised downwards in the face of the “large number of negative shocks” in recent months. Next year their forecast is growth of 1.4%. It leaves the German economy as relatively resilient to the fallout from what is happening in financial markets and the slowing US economy. It is expecting unemployment to fall although at a slower rate than previously. It is forecasting that domestic consumption will expand whilst exports weaken. The think tank expects 2.6% inflation this year falling to 1.8% next year. The IFO’s business confidence index fell in April to 102.4 from 104.8. The German Economics Ministry now forecasts growth in real terms of 1.2% in 2009 compared with its original forecast of 1.4% with growth of 1.7% this year.

In France, President Sarkozy has the major job of improving French finances and increasing the competitiveness of the economy. In recent years, it has lost out significantly to Germany. The task facing France in improving public finances was laid out in a parliamentary report from the French Senate. If France is to eliminate its public deficit by 2012, it estimates that spending cuts and tax increases worth a cumulative total of €80 billion are required. Recently, the government was forced to revise up its budget deficit forecast for 2007 to 2.7% of GDP compared with the 2.4% it had forecast. It has also raised its forecast for the deficit for 2008 from 2.3% to 2.5%. The forecast for growth this year is 1.7% to 2.0%. The President has sought to take measures to bring the budget deficit down to zero by 2012 and plans public spending cuts and savings which would cut public spending by €7 billion a year with about €1 billion to be handed back to civil servants through higher pay from 2011. Such savings are notoriously difficult to achieve in France because of the size of the public sector but weaker economic growth might strengthen the determination of the President to achieve these plans. The balanced budget promise has already been put back from 2010 to 2012.



French consumers are not confident at the moment. Consumer spending fell by 1.7% in March compared with February and, according to Insee, French consumer confidence is at its lowest for more than two decades. Its morale index declined to -37 from -36 in March. The rise in inflation in France has caused a 2.3% increase in the national minimum wage. In the year to March, prices rose by 3.5% which is the fastest annual rate of increase for eleven years. This will mean that two million employees who receive the minimum wage and several million others whose salaries are set in reference to it could see two pay increases this year. Thus, cost pressures will be exacerbated. Notwithstanding the prospects of an economic slow-down, the combination of low share ratings and reasonable dividend yields still represent a compelling case for important exposure to European markets.

Conditions in the UK are becoming increasingly difficult and the sharp fall in sterling in recent months is one indicator of changing sentiment towards the UK. The huge increase in public spending in recent years, way beyond the growth rate of the economy, has led to the predictable problems with government finances now. Apart from the financial turmoil which has affected the UK, like the USA, the housing market is now starting to turn down, threatening a negative wealth effect. The government faces a very difficult task in restoring public finances and confidence. To add to its embarrassment, the EU is starting an excessive deficit enquiry into the UK's public finances. Although it has no authority to take action against the UK, given that sterling is not a member of the Eurozone, it is nevertheless a significant embarrassment. At a time when, as we have just noted, Eurozone government deficits collectively more than halved in 2007 to 0.6% of GDP, the trend is the opposite in the UK, and with government economic forecasts almost certainly far too optimistic, a significant worsening of public finances seems likely.

At a time when economic conditions are becoming more difficult, any government would like to be in a position, as has happened in the USA, to take offsetting fiscal action to try to provide a stimulus for the economy. That no such action is possible in the UK, reflects the very poor state of public finances and, contrary to good economic sense, taxation continues to be raised into a downturn. Besides the problems over the taxation of non-domiciled UK residents, capital gains tax and now the threat of some significant companies to move away from the UK, other people are feeling the squeeze through tax increases, whether it be on cars or individuals, hence the strong reaction to the abolition of the 10p tax band.

The problems with public finances have long been predictable. The Treasury has consistently underestimated the UK's borrowing needs but the situation has been exacerbated by the turmoil in financial markets which, amongst other things, threatens the housing markets as mortgages become more difficult to obtain. Falling house prices lead to the prospect of negative equity and consumer spending is almost certain to be affected by current conditions which risks exacerbating the economic slow-down. According to the IMF, house prices, following the property boom, are about 30% above what can be justified by fundamental factors.





There are a number of indicators of prices in the housing market and also conditions for mortgage lending. The latest figures from the Land Registry show that there was no increase in house prices in January and, in fact, prices fell in seven out of the ten regions. According to the Halifax, house prices fell by 2.5% in March. The FT house price index shows that UK house prices were flat in March. On an annual basis, house price inflation was 5.4% in March, down from 6.1% in February. The RICS said that 78.5% more surveyors around Britain said house prices were falling in March than rising and this reflects the most negative reading of the survey since June 1990. According to the Department of Communities and Local Government, house prices fell by 1.6% in February with the annual rate of house price growth slowing to 6.7% compared with 8% in January. The latest Land Registry figures show that its index of house prices fell by 0.4% in March following a downwardly revised fall of 0.1% in February, with the annual growth slowing from 5.3% to 3.6%. According to the Nationwide's measure of house prices, prices have suffered their first annual fall in twelve years with prices being 1% lower than a year previously.

According to the Bank of England, net mortgage lending in February rose by £7.4 billion, the same increase as in January. Mortgage approvals fell slightly in February compared with January, as did approvals for re-mortgaging. The Council of Mortgage Lenders said that total home loans advanced in March rose by 5% from February's level, a much lower level than typically seen. The British Bankers Association reports that mortgage lending fell by nearly 5% to a record low in March. The figure was nearly 47% below that in March 2007. The figure for new home sales in March was 8.5% down on the previous month and the lowest since 1991. The Bank of England reports that the number of mortgages granted to home buyers fell in March to 64,000 compared with 72,000 in February. This reflects the lowest figures since comparable records began in 1999.

As we mentioned above and have often mentioned earlier, the state of public finances in the UK is a major cause for concern since they can easily slip out of control if the economy slows down or slows down more than expected. In terms of economic forecasts, the Institute of Directors' latest forecast is that UK economic growth will slow to 1.7% this year and fall further to 1.5% next year. The Chancellor's forecast is for growth in 2009 of between 2.25% and 2.75%. The IMF's table shown at the beginning of this review indicates its expectations of growth of 1.6% this year and next year. The EC's forecasts are also lower than those of the Treasury. It forecasts that the UK economy will grow by 1.7% this year, which is in line with the bottom of the Treasury's forecasts, but by 1.6% next year, which, as we have just seen, is well below the Treasury forecast. It criticised the UK over its projected levels of public borrowing for the current and next financial years. It suggested that budget deficit would reach 3.3% of GDP on the calculation prescribed by the Maastricht Treaty and, as we mentioned earlier, has launched a formal procedure to examine this excessive deficit. The National Institute of Economic and Social Research forecasts UK growth of 1.8% this year and the same for 2009. Public borrowing for 2007 / 8 was £35.6 billion for the financial year 2007 / 8 compared with a projection of £36.4 billion in the budget but £2 billion more than predicted a year ago.

The Bank of England is obviously having difficulty in setting interest rates because there was a three-way split in the Monetary Policy Committee over interest rates when they were reduced from 5.25% to 5.0% in April. Six members voted for a 0.25% cut, one for a 0.5% cut and two voted for no change. The Bank of England indicated on 10 April, when it cut interest rates, that it was still concerned about inflation, noting the CPI stood at 2.5% in February, 0.5% above its target. It justified its decision to cut interest rates by the medium term outlook and stated "credit conditions have tightened and the availability of credit appears to be worse". It believed that business activity would slow down, thus creating spare capacity to offset inflationary pressures.



GDP growth was 0.4% in the first quarter of 2008 compared with 0.6% in the last quarter of 2007, with the annual growth rate falling from 2.8% to 2.5%. Within the total, the predominant service sector showed growth slipping slightly to 0.6% from 0.7%. Growth in business services and finance, representing 28% of the economy, fell from 0.6% to 0.4%. Construction industry growth was 0.5%. Manufacturing industry, now a small part of the UK economy, should benefit from the more competitive level of sterling.

As we have said, one of the features recently has been the sharp decline in sterling against most currencies, including the US dollar, although by a much lower amount. With a large current account deficit and a large internal deficit, the UK economy is unbalanced and one way of helping to restore the balance, to make it more competitive, is for sterling to weaken. We would not be at all surprised to see a continued fall in sterling even to a level where it overshoots, as often happens on the down-side as well as the upside. Confidence in the UK economy has fallen sharply and, although short term currency movements are difficult to forecast, we would not be surprised to see the currency continue its decline. Exposure to UK equities should have some bias towards overseas earners given rather poor short term prospects for the UK economy.

Turning now to Asia, the Asian Development Bank has forecast that Asia, excluding Japan, will show economic growth of 7.6% this year, a reduction on the 8.2% level forecast last September. The ADB warned that Asia ex Japan would not be sheltered from what was happening in the USA but did point out stronger domestic consumption trends and more diversification of trading partners. It particularly noted that links with oil exporting nations were increasing. It also noted that the banking sector was relatively strong. As we have noted before, its position remains relatively strong and the influence of Asia on world economic growth will be positive and provide some offset to the slowing down in the leading industrialised nations.

First quarter growth from China was 10.6% at an annualised rate. This was faster than expected and will mean that, in terms of domestic policy, China will be likely to raise interest rates, increase bank reserve requirements and, perhaps, let the currency appreciate faster. The latest move on bank deposits is to raise commercial banks' reserve requirements to 16% with the central bank, up another 0.5%. What worries the authorities is the sharp rise in inflation which is running at an annual rate of 8.3% in March, propelled by food prices. These rose by 21% in the first quarter, accounting for 6.8% of the 8% rise in consumer prices in that period. The government's target of 4.8% for this year looks unattainable. Industrialised countries and consumers are going to have to get used to the fact that Chinese imports are not going to be as cheap as they were and one of the downward influences on world inflation will gradually be diminishing. Nevertheless, the growth rates demonstrated by China emphasise how important the country is, together with other Asian countries, in providing support to the world economy.

It is important not to underestimate the problems of financial markets, on the one hand, nor to dwell too heavily on the present, on the other. Investors must look forward and take a view on the likely success of the monetary and fiscal stimulus applied in various parts of the world economy as well as moves to free up money markets. There are plenty of other concerns, food and energy prices, for example, but with shares generally reasonably rated, we think they discount lower economic growth in the short term and investors should focus on the measures being taken to restore economic growth. We believe the more stable conditions, which we have noted in international equity markets recently, are encouraging and reflect a realistic view of market prospects.

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