Affinity Consulting Group Ltd

Finding The Growth

27th May 2005

By Clive A Ward

Welcome to our May newsletter. As usual, there is a lot of information here, you may just want the performance information and commentary so I have structured this so you can pick it out easily.

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1. Affinity News

- I am are pleased to announce that Lee Sanders has been appointed as acting manager for Singapore. I have worked with Lee for 7 years and he is very experienced in the offshore market. Lee worked as an IFA in the UK for several years before coming overseas.

- In our UK administration office, Sian Dodsworth has moved on after 5 years with us. She has taken a job in HR with a large US company. Jacki Edwards has taken over management of the administration. Jacki has been running the call centre for 6 years and understands our business. She is a valuable addition to the team.

- Gemma Mackenzie has been with the call centre for 6 years and also joined the administration team to compliment Sue Bains who also joined 6 years ago.

- With many of our clients buying property, particularly in the UAE, can I remind you that we can arrange your life insurance and critical illness. We cover all forms of life insurance from 1 year renewable to whole of life.

- We also arrange comprehensive medical cover and specialise in schemes that cover you for international travel. In this respect, we strongly recommend Aviva (the renamed merger of Norwich Union, Commercial Union & General Accident) who are now the UK's biggest life insurance company. They have recently entered the market with a very competitive product at a price that beats other international players, such as BUPA.

- All insurances we arrange are portable and can be taken with you if you relocate.

- We are also experienced in setting company HR packages to cover group life, accidental death, disability, medical and pensions and would be pleased to assist your company.

- If you have not looked at our website, www.affinity-consulting.com please do take a little time to have a look. If you have used it, I would be grateful for feed back please. It contains:

  - Factsheets, prices and performance information for the main investments we recommend, updated weekly
  - Currency converter and daily summary of the main stock market indices, currencies, interest rates and precious metals
  - Information on expat mortgages, which we can arrange for you (except in UAE)
  - General explanatory information on types of insurance
  - Explanatory information on trusts
  - Financial planning information, including how much to save for a pension.
  - Graphs of the major stock markets, currencies, property prices and inflation in the Useful Information section

  And much more!

2. Introduction

It has not been a good year so far in any major market. Most of what I predicted in January is bearing out. Rising interest rates in the USA have caused bond yields to reduce and combined with high energy prices, they have slowed the stock markets to a halt. After a 2 year bull run, the western stock markets are down and may have topped out for a while, the emerging markets are up. Commodities have dropped suddenly after a long run up (despite the oil price). The global property boom is showing signs of ending with prices dropping in Australia and UK, although it is still booming in mainland Europe and the USA. Commercial property is still showing robust growth. The lack of volatility in all markets and large inflows of cash has also meant a bad year for hedge funds so far. Most fund managers are now looking to Asia for growth.

Corporate earnings in the US and UK are getting stronger but much of this is already priced into the markets, making the price/earnings ratios of US companies a little on the high side. Corporate earnings are generally very strong and this bodes well for capital investment, mergers and takeovers, dividends and share buy-backs. By contrast, the price of many of the companies in the Asian markets is relatively low.

Global growth is slowing, even China and India whilst still growing strongly, are growing more slowly this year, which in China's case should prevent overheating of the economy. In the USA, income growth is lagging inflation and will lead to a slow down in consumer spending. UK and European consumers' spending has already slowed. However on the bright side, with the exception of mainland western Europe, most countries are seeing economic growth, which should result in equity growth, but I would not expect to see dramatic equity growth outside of Asia for a while. Emerging markets have been the best performers this year, with Latin America leading the group.

Hedge funds have been in the news recently and there has been much hype about the recent slow performance, much of which is poorly researched as these are more complex investments. I have covered this further on, but essentially, events have conspired to cause low returns recently in most hedge funds strategies, even though they are not correlated. This does happen from time to time and is not a major cause for concern. With over 8000 funds, many of which are highly leveraged and very specialised, some may go under. However, the fund of funds approach which we recommend, will smooth these returns and those that we work with are beating the index.

For the first time since 2001 investors in UK would have had greater returns by choosing shares over residential property according to research by the Investment Property Databank. Last year residential investment property returned an average of 9.1% (capital gain and rent combined) while the FTSE All-Share index was up 12.8%. This is the first time the world has experienced a global property boom and the situation in UK could be reflected in the rest of the world in the coming years as the property boom ends.

Many pundits are predicting that for the next year, growth in most asset classes (bonds, equities, property, commodities) in the main markets will be slow. Hedge funds are an investment style rather than an asset class. Most hopes seem to revolve around the emerging markets, with Asia the main focus of attention. We are entering the period of the year when equities are traditionally weak. The coming months will be a time when active management of investments will be necessary to find the areas showing growth and to select the right funds to stay on top of it. Collins Stewart believe there are selective growth opportunities in such places as

- oil companies with their huge profits on the back of price rises
- Japan, following corporate restructuring and reduction in non performing loans
- quality companies with strong cash flows in several regions of the world

Significant short term growth will be difficult to find, but it is a good time to be investing for the medium – long term. This is a time where actively managed funds of funds such as those we work with, should out perform the market as they have been good at finding the right mangers with whom to invest, so far. It is also a good time for monthly savers who "average in" at different prices as markets go up and down.

3. Market & Fund Performance

The US market is down this year, the Dow Jones (top 30 US companies) by -5.5% and the broader Standard & Poor's 500 (top 500 US companies) by -4.5%. The FTSE 100 (top 100 companies in UK) has almost stood still at -0.03%. The weighted index of all world stock markets represented by the Morgan Stanley Capital Index has risen 6.5%. Since about half of the index is represented by the American market, it is clear that the emerging markets have shown strong growth, as Europe has not performed well.

The bond market is struggling. Sovereign debt (government bonds) are declining in value as interest rates rise. High yield bonds which generally invest in "junk bonds" (those below investment grade) are performing well. These pay higher rate of interest and with reasonable (although slowing) economic growth in most non European countries and strong corporate earnings in the US, UK and emerging markets, the default rate is low.

Hedge funds have been very static this year. There has been some volatility in commodity markets but in too small a range for the commodity trading funds to benefit and it has caught many of them "on the wrong foot" and they have taken losses. The downgrading of GM and Ford debt has also caught out many convertible arbitrage funds and this is discussed later.

Commodities have had a strong run for the past 3 years and are approaching their all time highs of 1981. This has been fuelled by demand from China and Asia generally, but this is slowing. Commodities are very volatile, they lost 30% between 1995 & 2001 and over 10 years have gained only 17.5% (1.8% per annum). The growth rates of the past 3 years are not sustainable.

Despite the fact that the S&P 500 (the index of the top 500 US companies) is down by 24% since the peak at the turn of the century, I wanted to put this in perspective. All markets go in cycles and we are advising on investments over the long term. The following table and statistics produced by Lord Abbott, show the annualised returns of the S&P 500 over a rolling 10 year period. You have to go back to the onset of the 2nd world war or the great depression of the 1930's to see negative returns over a 10 year period. The long term return is 10.4%.

Period	Return	Period	Return	Period	Return
1936 - 1945	8.4%	1958 - 1967	12.9%	1980 - 1989	17.6%
1937 - 1946	4.4%	1959 - 1968	10.0%	1981 - 1990	13.9%
1938 - 1947	9.6%	1960 - 1969	7.8%	1982 - 1991	17.6%
1939 - 1948	7.3%	1961 - 1970	8.2%	1983 - 1992	16.2%
1940 - 1949	9.2%	1962 - 1971	7.1%	1984 - 1993	14.9%
1941 - 1950	13.4%	1963 - 1972	9.9%	1985 - 1994	14.4%
1942 - 1951	17.3%	1964 - 1973	6.0%	1986 - 1995	14.8%
1943 - 1952	17.1%	1965 - 1974	1.2%	1987 - 1996	15.3%
1944 - 1953	14.3%	1966 - 1975	3.3%	1988 - 1997	18.1%
1945 - 1954	17.1%	1967 - 1976	6.6%	1989 - 1998	19.2%
1946 - 1955	16.7%	1968 - 1977	3.6%	1990 - 1999	18.2%
1947 - 1956	18.4%	1969 - 1978	3.2%	1991 - 2000	17.5%
1948 - 1957	16.4%	1970 - 1979	5.9%	1992 - 2001	12.9%
1949 - 1958	20.1%	1971 - 1980	8.4%	1993 - 2002	9.2%
1950 - 1959	19.4%	1972 - 1981	6.5%	1994 - 2003	11.0%
1951 - 1960	16.2%	1973 - 1982	6.7%	1995 - 2004	11.1%
1952 - 1961	16.4%	1974 - 1983	10.6%		
1953 - 1962	13.4%	1975 - 1984	14.8%		
1954 - 1963	15.9%	1976 - 1985	14.3%		
1955 - 1964	12.8%	1977 - 1986	13.8%		
1956 - 1965	11.1%	1978 - 1987	15.3%		
1957 - 1966	9.2%	1979 - 1988	16.3%		

Avg Annual Compound Growth Rates

Period	Rate
1926 - 2004	10.4%
1945 - 2004	12.0%
1970 - 2004	11.3%
1980 - 2004	13.5%
1990 - 2004	10.9%

Another way of looking at this is that if the S&P500 is down by 24% since 2000, then history points to it recovering at least this amount in the next 5 years. Unless you believe things are likely to be worse than 1930's depression, the index is likely to gain more than 24%, to end up positive over the 10 year period. In fact, for it to achieve the average growth of 10.5% pa over the decade, it would need to grow by 24% per annum until 2010. To equal that of the worst 10 year period since the war (1.2% pa 1965-1974 when the Arabs turned the oil off) it would need to grow 4.3% per annum for the rest of the decade.

Make of it what you will. Even though it is likely to be lack lustre year in western markets, the prediction of the economist in January that this will be the year when the big adjustments that usually happen early in the global growth cycle finally start to take place, could be true.

Performance Table

I have added the Credit Suisse First Boston Hedge Fund index below. This is in 2 forms, all hedge funds and only those that are open for investment. This goes to prove that the best performing hedge funds are closed. This is where investing through a fund of funds (such as Infiniti Capital) pays off, as these can lock in capacity with closed funds that they have helped establish with seed capital.

I have also added the gold price, as a reference. It is also very volatile and has benefited from the weakness of the US dollar

I have added the Goldman Sach's commodity index for comparison, but this is weighted 72% towards oil & gas. You will see it has outperformed the stock markets over the past 3 years.

Sterling investors in USD assets will have seen a 5% currency gain over the past 3 months as the dollar strengthened against sterling. This will help to recover some of the currency losses for sterling investors over the past 4 years.

To 30th April 2005

	Price	1 month	1 year	since 1 Jan 2002	
S&P 500 Capital Return	1157	-2.0%	4.5%	-0.6%	
Dow Jones Indust Cap Return	10193	-3.0%	-0.3%	-3.6%	
NASDAQ Capital Return	1922	-3.9%	0.1%	-0.4%	
FTSE 100 (in GBP) Capital Return	4802	-1.9%	7.0%	-9.2%	
MSCI World Index Capital Return	1124	-2.4%	8.5%	12.0%	
Goldman Sach's Commodity Index	5857	-9.3%	15.1%	105.2%	
CSFB/Tremont Hedge Fund	317	-0.2%	7.0%	31.7%	
CSFB/Tremont Investable	109	-0.2%	3.7%	22.6%	
Gold Troy Ounce	437	1.9%	12.1%	51.0%	
FRIENDS PROVIDENT FUNDS					
Collins Stewart Aggressive (USD)	1.392	-0.3%	10.6%	52.0%	
Collins Stewart Growth (USD)	1.089	-1.4%	6.7%	20.6%	
Lanson International Growth	1.153	-1.0%	2.3%	24.0%	Since launch in Mar 2002
Lanson Optima Fund	0.697	0.1%	3.0%	17.0%	
Momentum All Weather (USD)	1.137	-0.4%	3.5%	14.2%	
Student Accommodation (GBP)	1.331	0.5%	7.3%	26.3%	
NOT AVAILABLE THROUGH FPI					
Barclays Infiniti Capital Note 138	995.3	-0.9%	-0.5% since launch		Estimated price, launched Dec 04
Infiniti Security Fund	873.2	-0.1%	-1.5%	20.7%	Estimated price
Infiniti Growth Fund	849.7	-2.2%	0.6%	32.7%	Estimated price
Infiniti Momentum Fund	888.3	-1.6%	0.2%	47.0%	Estimated price
Protected Asset TEP Fund (GBP)	1.424	0.6%	7.4%	23.1%	
Protected Asset TEP Fund (USD)	1.097	0.6%	7.2%		Launched Dec 03
Protected Asset TEP Fund 2(GBP)	1.165	0.6%	8.3%		
Quadriga GCT USD	2,071	-15.5%	-5.0%	88.1%	

Details of all these can be found on the investments page of our website:
http://www.affinity-consulting.com/investments.php

The **Lanson** funds of funds have beaten the Dow Jones index over the past year and have beaten all the main market indices so far this year. Over the past 3.3 years they have considerably outperformed the main western markets and by their use of emerging markets and their "stop-loss" strategy (that puts them heavily in cash when markets fall), they have grown by 58% (Optima) and 100% (LIG) more than the growth rate of the world index.

The **Collins Stewart** funds of funds have also performed well. They have fallen behind a very small amount this year but over the past 3.3 years their USD Growth fund has beaten the world index growth rate by 71% and their USD Aggressive fund has been stunning by gaining 333% of the world index growth rate. Their Aggressive USD fund has gained 52% whereas the US, UK and European market are still negative since January 2002.

The active management strategy that these 2 fund of funds mangers follow, is out performing most other managed funds which are not so actively managed. Lanson have performed better than some funds which have received awards from Standard & Poor's last year. The Collins Stewart Aggressive fund has outperformed most funds of hedge funds over the last 3 years. We recommend that clients diversify between the 2 managers, according to their risk profile.

The **Infiniti Capital** hedge funds have also had a slow year so far, but they are still well ahead of the CSFB indices over the last 3.3 years. Their Momentum fund has grown 48% more than the hedge fund index over this period and by 113% more than the investable hedge fund index.

Quadriga had a bad January, recovered a little in February and March and then took a 15% drop in April. All commodity trading funds had similar problems, including the biggest, run by the MAN group.

The **Student Accommodation** fund will still accept new money but will not allow switches of existing money into it. It has maintained its consistent growth of 7-8% per annum and is expected to be able to sustain this, even if property prices slow down. The fund plans to open 2 new halls of residence this year.

The **FPIL Momentum All Weather Liquidity** fund has seen slower performance as it took in too much money and had to close the main fund and restructure. This heavy weight of cash acted as drag on the growth.

The **Protected Asset TEP Fund** (PATF) invests in traded endowment plans and has been particularly skilful in the acquisition and accounting of these, enabling it to see consistent high returns for a low risk fund. It also hedges to US dollars and euros. They have also launched a new fund, imaginatively called PATF 2 and this is performing better, as it was launched at the bottom of the markets and has been buying endowments at very good prices.

The **Asset Backed Securitization Bond** that we brought to your attention at the end of last year has another tranche. The 5 year bond guarantees your capital and a coupon of 10% per annum in USD, sterling or euros. What is more, the original tranche is now being rated by S&P at A (or better) and will be floated on the Luxembourg exchange and so those of you that have already bought it, could sell it at a substantial premium (15-20%). It is planned to float subsequent tranches as well, so this gives you the choice of holding the bond and receiving your 10% each year, or selling it for a premium and buying another. It is rather like an IPO but for a bond.

Currency fluctuations may well have played a part in the performance of your investments. If your home currency is not USD based, then some of your gain will have been eroded by the weakening of the dollar. However, many international funds that are priced in USD are holding assets in another stock exchange in local currency. Consider a $1000 investment in European fund when the euro was at $1.0, you would have bought 1000 euro's worth of stock. Assume the stock price did not move but the USD is now $1.25 to the euro, your investment is now worth $1250. If the euro drops, then the investment value in USD will decrease. The more aggressive Collins Stewart and Lanson Financial funds moved most of their assets outside of the USA last year in anticipation of the weakening dollar and of higher market gains. This also increased their exposure to these more volatile markets.

4. Where To Invest for 2005? (for new readers)

It can be difficult for the layman to keep up with the trends in the world and for a busy person to monitor their investments closely. With so many investments to choose from 2 things become important:

1. Use a fund manager if you do not have the expertise yourself. Even they do not get it right all the time so what chance do you have? The advantages are:
   - They are professionals and spend all their time studying investments to spot trends, find bargains etc.
   - They have economies of scale and can deal more cost effectively
   - It allows smaller investors to pool their money and spread it over a larger number of investments than they could manage on their own and so reduces risk.

2. Use actively managed funds where possible. As the world changes so much over the life of an investment, you need to know that your money is being applied to the best regions. An active manager will allocate his money to the regions and funds that are showing the best growth, he will not leave money allocated to funds during their bad years, simply waiting for them to recover.

This is why we have chosen Collins Stewart and Lanson Financial, as these fund mangers are both active managers running funds of funds. Their track record over the past 3 years has been good relative to the markets and to their peers. Over the period, they have made many changes of allocation and have used many of the Eastern Europe and Asian funds, also bonds, gold and commodities. They are mainly focussed on equities, as traditionally this is where there is most potential for growth, particularly on a world wide basis.

The other factors to consider are

1. How long you want to invest
2. The amount of risk you are willing to take. Risk is about volatility and time, the longer you remain invested, the lower the risk becomes. Investing in equity funds for 1 year is very risky but for 10 years, the risk is very small. This can be seen from the 3 year figures in the table above. Even the FTSE is likely to recover and show reasonable growth in the next 7 years.
3. Your base currency. Undoubtedly there are more funds available in US dollars but many either hedge to euro and sterling or offer investments in these currencies which have different asset allocations to the dollar versions. (Collins Stewart run sterling funds for example)

This year is likely to be one where we see:

- Emerging Europe and Asia outperform the US, UK and Europe in equity markets
- hedge funds do better than last year but maybe not the stellar performances of 3-4 years ago
- property funds continue at 7-9%
- bond yields decline as interest rates rise in the USA
- gold to move inversely with the value of the US dollar and commodities in general slow their rapid rise as growth in USA and China slows.
- world economic growth slow a little.

Long term monthly savers are best served by diversifying between the Collins Stewart and Lanson funds. Particularly in the early years of the plan, as you are building up capital, the volatility is not so significant. As you near the end of the term, you could move some of money to lower risk funds such as Momentum All Weather or property or bonds.

Lump sum savers need to identify their time frame and risk and diversify across a number of asset classes.

- Short-medium term (5 years or less) savers can use the PATF in sterling (av 8% pa), USD (6-7%) or euro and there is a similar fund for Australian dollar investors, the LM Mortgage income fund returning 7% pa on the A$. Also, the Asset Backed Securitization Bond pays 10% pa (8.5% pa over 3 years) and it plans to float on the Luxembourg exchange, enabling an early exit at a premium.

- Medium-long term savers can use the Collins Stewart and Lanson fund of equity funds.

Capital guaranteed hedge fund

- Infinity Capital launched an 8 year capital guaranteed fund (by Barclays Bank) last December that invests in their 3 funds of hedge funds. At the end of April it is 0.5% below the launch price and you can still invest in this until the end of June. Despite this though the funds into which it invests have achieved 15.3% pa since launch in May 1999. This Note provides a degree of leverage that would have increased this performance by 3-4% pa over that period. At the end of 2012 you come out of the fund at the higher of :
    - The end price
    - 80% of the highest price over the 8 years
    - The launch price (if the fund drops in the next 2 months, you could have a guarantee for a higher amount than you invest. The converse is also true)

Please do contact us if you would like to review your situation.

5. Economic Outlook

As usual, I have distilled a large number of economic reports over the past months. I have put together this consensus for you and hope you find it useful.

I wrote in my last newsletter that "The Economist" forecast that we could see the foundations of a period of global growth being laid this year, with an early season slow down preceding a period of sustained development. We are certainly seeing the slowdown, time will tell if the development phase follows.

When I last wrote the markets were very preoccupied with:

- oil supply
- the effect of increasing interest rates on the US economy and on global growth
- the weakness of the US dollar
- how much the application of the brakes to the Chinese economy will affect global growth

Since then, OPEC has increased their supply of oil and at 33 million barrels/day, is now operating close to capacity. Other producers still have plenty of supply, notably Russia, Nigeria and Venezuela. The price has stabilised at the $50 per barrel level and the world is getting used to it. As world economies are expected to slow this year, so demand will stabilise and it is unlikely that the predictions of Goldman Sachs that oil will rise to $100 per barrel will be anywhere close to being realised. It is more likely oil prices will fall over the summer.

The US Federal Reserve has taken the sensible path of raising interest rates slowly to head off inflation. A fast rise would have a severe effect on the economy as it would slow capital investment, make mortgages more expensive and so cause problems in the housing market and it would encourage the population to save more and spend less, prompting an even greater economic slowdown. Whereas a little of this would be good for the economy, too much would halt consumer spending and capital investment and plunge it into recession. This was Keynes's paradox of thrift: more saving is good, but too much more, too quickly, is bad.

Contrary to expectation the US dollar has strengthened as a result of increasing US interest rates, whilst those in Europe have remained static. The inflow of foreign funds into the USA has continued. There is such a high degree of interdependency between the USA and Asia that nobody, other than speculators, would gain from a collapse of the dollar.

I will cover China later, but their slow down is gradual so far. The government has acted to curb bank lending to stop over heating. However they may have a problem with many non performing loans, particularly at local government level.

The other concern at present is the state of hedge funds. The downgrading of Ford and General Motors bonds to junk status caused shock waves. Of the 8000 hedge funds over some 30-40 strategies, the one strategy most exposed is convertible arbitrage. This is a complicated strategy that involves buying bonds from a company in the expectation it will rise and then selling their stock short in the expectation it will fall. To make more profit, the trade is leveraged. Now Kirk Kerkorian made a bid for GM at the same time as their bonds were downgraded. The bond price went down and the share price went up, blowing many of these leveraged trades apart. It may send a few of the specialised hedge funds into liquidation and it has focussed attention on the whole industry. However it is unlikely to have a severe affect on the whole market.

The other pressure on hedge funds is that they have been receiving large inflows of cash which dilute earnings until they are invested and at the same time, many funds have been unwinding some of their leverage (borrowing). This is because many of the markets have been flat or declining and this has affected their performance, as the gains they have made have not had the leverage they enjoyed previously.

On the positive side:

- inflation should continue at the present low rates
- interest rates are close to their peak in UK & Europe and may not rise much further in the USA
- house prices worldwide will cool or fall modestly but should not crash
- the oil price will remain high, but has probably peaked.

Growth

- **The British economy** is still seeing record levels of employment and low inflation. However, consumer confidence has dropped rapidly this year and savings have dropped from 9.7% of income in 1997 to just 5.6% last year. Consumer spending should rise in line with gross domestic product (GDP)

but under Labour, it has been running at 1.5 times the rate of growth of GDP, fuelled by cheap money and remortgaging property. The government need to encourage savings as the percentage of the population in work declines as people live longer, if not, the future will be a lot poorer. This reversal may have started as retail sales this year have been severely down and consumer spending has tracked the rate of GDP growth. This implies the economy will slow down this year. For the first time since 2001 investors would have had greater returns by choosing shares over residential property according to research by the Investment Property Databank. Last year residential investment property returned an average of 9.1% (capital gain and rent combined) while the FTSE All-Share index was up 12.8%.

- **The American economy** is slowing and expected to achieve 3.3 - 3.6% this year, depending on who you read, against 4% last year. Wages are not keeping pace with inflation, they grew an annual rate of 2.3% over the first quarter, which lagged inflation by 0.5%, but unusually in these conditions, productivity in increasing. This is probably due to increased competition from China. Combined with interest rate rises, it has caused consumer spending to slow. Savings are still at an all time low of 1.5% of gross domestic product. Corporate Profits represent 10.88 % of GDP, their highest level since 1987. Meanwhile wages represent 46.2% of GDP the fifth lowest since 1947. Whereas the consumer sector has kept the US economy growing in recent years, it could be capital expenditure that fuels it in the coming year, provided confidence remains strong.

- **Europe**, by contrast is still struggling. It has seen an 85% increase in oil prices and has a jobless rate of 8.5%. It will be lucky to achieve 1.5% growth this year (less than 2% that was predicted last October). Germany is suffering from record high unemployment at 12% and weak consumption caused by restrictive labour markets and is the weakest. Germany has some of the highest labour costs in the world. They are 44% higher than the USA, 50% higher than Japan 380% more than Central Europe and a staggering 510% more than China (according to Credit Suisse private banking). France and Italy are struggling to achieve growth. Because of this, interest rates have remained constant, - so far. Germany, Italy, Greece and Portugal will exceed the EU budget deficit limit of 3% of GDP this year.

- **Emerging Europe** has seen some profit taking in the stock markets after many years of strong growth. Confidence in Russia has been dented over President Putin's aggressive stance on breaking up Yukos. This is seen as a political move to remove an opponent and for the state to regain control of its oil reserves. The question on investor's minds is: was this a one – off?

- **The Japanese economy** is forecast to grow at 2% in 2005. However there is little sign yet of any real growth emerging.

- **The Chinese economy** grew at an annualised rate of 9.5% in the first quarter, fuelling fears of overheating. The government has acted with tougher controls on land and bank lending (especially for property) and to stop bailing out bankrupt companies. The banking sector needs cleaning up as there are too many soft loans, reminiscent of Japan a few years ago.

- I read extracts from Chicago journalist Ted Fishman's book "China Inc, How The Rise Of The Next Superpower Challenges America And The Rest Of The World" where he points out that China makes 1/20th of everything produced in the world, but on the world stage it plays the role of a new factory in an old industrial town. It can spend, bully, hire and dictate wages, it can throw old line competitors out of work. It changes the way everyone does business.

  US consumers are getting used to paying less for Wall Mart products made in China. Consumers do not want to pay US wages, yet they complain that US manufacturing is moving to China and putting Americans out of work. The French group Carrefour said that 90% off all DVD players they sell come from China at $30. That is why the US is running such a high trade deficit and Europe is suffering too. The US – China trade imbalance has forced China to accumulate reserves of $600 billion and most of this is invested in US treasury bills. Hence there is a very strong interdependency between the 2 countries. Without the US to buy Chinese products, China cannot sustain its growth; without China to lend money to the US, American cannot spend. Without the twin engines of USA and China stoking the fortunes of other nations, the rest of the world would splutter.

  US manufacturers say the Chinese yuan is 40% undervalued against the US dollar. The Japanese have added their urging to that of the US, and with Europe pressing the Chinese hard on textile imports, letting the yuan strengthen would ease China's relations with its major trading partners.

  Jim Jubak of MSN Money writes: There are the purely domestic arguments for allowing the yuan to appreciate. To keep the yuan pegged to the dollar, the Chinese central bank has to buy a big chunk of the

dollars flooding into the country to pay for exports in exchange for yuan. Then, to keep that increase in the yuan money supply from igniting inflation, Beijing has to sell bonds. (Selling bonds has the effect of taking money out of circulation, since investors give up yuan and get bonds in return.) That gets expensive, especially because the Chinese central bank has had to pay higher interest rates to get investors to buy recent offerings.

Wall Street currently believes that the only thing preventing the Chinese from revaluing the yuan is a desire not to reward the currency speculators who have made big yuan buys in anticipation of a currency appreciation. How much of a jump in the value of the yuan is Wall Street projecting? Merrill Lynch is among the biggest yuan bulls. It predicts a 10% increase. Other analysts project smaller gains against the dollar of around 3% to 5%. Even a 10% rise wouldn't make much difference in the U.S./China trade deficit. Like all other "solutions" that are built on reducing the demand by U.S. and other developed-world consumers for Chinese goods, the yuan-appreciation solution founders on the size of the difference in costs, especially labour costs, between the U.S. and China.

China wants to keep the world guessing and extract maximum political advantage, but then if it does revalue, it is likely to be in small increments.

Interest Rates

- **The UK** base rate is 4.75% and is unlikely to rise this year. Some predict it may even fall.

- **The US dollar** base rate is 3.0% and is predicted to rise to 3.5%.

- **The euro** base rate has remained constant at 2% and is unlikely to change short term.

Currencies

- The US dollar has risen on the back of rising interest rates which have widened the gap with the Euro rates. However many analysts believe this is a short term bounce and that it will decline again.

- Sterling and the euro have fallen against the dollar, more because of the dollar strength and worries about the political situation in Europe. The market also thinks the Bank of England will cut interest rates which is weakening sterling.

Markets

- **The US stock market** is still expected to show growth this year but it will be lucky if it reaches double digits. Companies are generating cash for major capital projects and if they start to apply this, the markets will react accordingly. Against this, the technical analysts who ignore economic fundamentals and try to predict the markets based on analysis of charts of the past, predict a major drop in the USA market next year. As always, for every optimist there is a pessimist and there are those who fear a housing crash and a considerable drop in consumer spending. If everyone agreed, the journalists would go out of business.

- **The UK stock market** has been slower to recover from the crash than most of the world's markets and so is still at the same level as at the start of the year. It is expected to show only very modest growth this year, possibly a little more than is expected in the US markets.

- The major gains last year came from the **emerging markets** once again, with Latin American being the strongest. There has been profit taking in the Eastern European funds and concerns over Russia following the government foreclosure on Yukos. India remains very volatile. China is too small and unstable a stock market for serious money and with the expected revaluation of the Chinese yuan, most funds invest in companies that make their profits from doing business in China.

Property

- The Economist is still arguing (as it has been for years) that houses in America, Australia, France, Ireland, Spain, The Netherlands and UK are overvalued. House prices and rents are linked and rents are low while house prices are high. In investment terms, the p/e (price/earnings ratio) is too high. On this basis, property in Australia, Spain & UK is 60% overvalued and 46% in France. In UK the average length of ownership of a house is 7 years. If you live in a London flat costing GBP 450,000, then at

current interest rates and using long term average growth rates, they calculate you would save GBP 35,000 over the 7 years by renting, taking into account all costs including buying and selling.

- Annual house price inflation in USA is 11%. The UK slowed to 10%, but in France it is running at 16%, Spain 17%, Italy, Sweden and Belgium around 10%. Germany however has fallen and average European houses have risen 12.5%. Australia fell 7% but Sydney fell 16%.

- The number of house sales in UK dropped last moth to the lowest since the housing slump of 1991 and there is strong anecdotal evidence that prices are falling. I can vouch for this first hand as my daughter is buying a house in west London and she offered 90% of the asking price of a house in January and they laughed at her. Last week they came back to see if her offer was still open.

- The **Dubai** property market has seen dramatic growth over the past few years but suddenly it is slowing signs of slowing. Sales agents now have to work to sell properties and they are not all selling immediately a development is announced..

Well done for getting to the end, I hope you found it useful.

Clive Ward