We are reporting good quarterly numbers to our clients – for obvious reasons a pleasing thing to be able to do, but its continuance cannot be taken for granted. This is more than natural modesty. The key to the year 2008 was guarding against a debt-strewn dislocation; the key to 2009 was to understand that the largesse of government cheque books would galvanise not only sentiment, but national economies, too. Get those big themes right, and you made money. The big theme for the future is of high inflation, and negative real interest rates. While these developments can appear suddenly and quickly, we are not particularly hopeful (or is it fearful?) that this is the story for 2010. In the meantime, markets will be jostled by a series of conflicting cross-currents, and it will be hard to judge both their sequence and their comparative importance.

The result of this is that success in the markets over the course of the next nine months will probably depend on opportunism. We remain convinced that the ultimate resolution of this time of uncertainty will be through high inflation – but first we have to get there. The management of the portfolios will require on the one hand, not to be bounced out of our core investments which protect the portfolios for this future development, and, on the other, not to sit disconsolately only in assets which in the short term may seem inappropriate.

What are the elements of the cross-currents? The first one is bullish. Underlying economic growth remains firm across the established world. Many investors have been surprised – not to say incredulous – at the snapback in prosperity over the last year. There is a biggish constituency of bears waiting for its end – and they are set to be disappointed. We think that economic growth figures, unemployment and company profits are all set to produce favourable surprises. This is a continuation of a trend.

At the other, bearish, end of the scale, we think that China looks pretty flaky at the moment, manifesting all the hallmarks of a seraphic over-exuberance. Most bubbles have at their core an undoubted truth and the difficulties occur when unrealistic implications are drawn from the basic observation. The tyranny of the dotted line, stretching into the future, is where the heresy is incubated. China is a text-book example of this phenomenon. In the last generation, the nation has changed out of all recognition. The existence of 1.3 billion people, most of them still dirt-poor, shows what a driver of the world economy an energised China could be. Tired communist governments now look rather astute, and their inscrutability adds to the idea that there is a master plan. Unlike India, whose patron saint is the pothole, China is bursting with new infrastructure products. Capital investment at 58% of the economy puts the rest of the world to shame – but it also broadcasts a command economy which is completely out of control. How about this for a quote from China's Housing Minister last month? In response to a question whether Beijing could stabilise home prices he said, 'We can definitely stabilise them! The premier has said so! So how can we not stabilise, we can for sure! Even if we can't, we can!' Not even Harold Wilson at his most manic talked like that. The same E.coli bug is at work in China as it has been in the rest of the world: interest rates held below the natural rate for an indefinite period. The West has seen its unfortunate consequences in the last two years; in China they are yet to manifest and the timing is uncertain. But it is the same disease, and when we look back at the 2008 crunch in the West and the crunch to come in China, that will be confirmed.

The situation concerning Greece is complex. The British are enjoying the cine-film of the EU emperor revealing himself to have no clothes, but the pleasure of all the Pathé films in the world would not disguise the fragilities under-girding the EU system. There is an uncanny parallel with 'sub-prime'. Even after it became clear that sub-prime mortgages were largely valueless, there was a view in the United States that their comparatively small size (about $250 billion *in toto*) meant that there could be no systemic risk. The nature of the derivatives market proved otherwise, since they were a constituent part of a much broader block of collateral which, when compromised, resulted in substantial losses in other supposedly riskless areas, relentlessly impairing the balance

sheets and lending capacity of US banks. Continental European banks were also involved in the US problems, and now they have an additional issue with Greece. EU sovereign bonds – of which Greek bonds are a part – are used extensively in collateral baskets within the European financial system. Increased risk aversion towards these credits forces a contraction of the lending system, reducing leverage and credit availability; Greece may only be 2% of European sovereign debt, but as with subprime, the knock-on effects are large as the liquidity multiplier works in reverse.

There has been an interesting development in the swaps market which is pertinent to the Greek situation. This seemingly arcane area of the market is an important one, since it allows any financial institution to readjust the duration of its borrowing or lending without having to go to the trouble of trading the underlying assets. The swaps spread is really a yield, and given that there is a counterparty risk (you take out the swap with a financial institution, which could go bust – and sometimes does!) the yield is always higher than the government bonds on which the swap is based (which, by definition is guaranteed by a government, not a bank). Recently, however, the swaps spread has yielded less than government bonds. This might seem an arcane and uninteresting fact, but it is the financial equivalent of water flowing uphill. Regulators want banks, which look obese in gross asset terms, to slim down. Government bonds meanwhile offer wonderfully attractive risk adjusted yield spreads, providing an incentive for banks to expand balance sheets by buying them. The resolution of this is for banks to get exposure to these spreads synthetically in the swaps market rather than actually buying and holding the bonds on their balance sheets: hence the anomaly. But the dynamic is clear: following the relentless drumbeat of aggression from the regulators, post-Lehman, banks everywhere are rationing, reducing and simplifying their balance sheets.

Japan remains intriguing. It is the one economy which has not benefited from quantitative easing. The result is that Japan remains anaemic: sluggish retail sales, low borrowing, poor growth in hourly wage rates, an economy teetering on the edge of deflation. Each of these symptoms would be cured by a blood-transfusion. It is our belief that a powerful stimulus to Japan would weaken the currency, steepen the yield curve, and the lugubrious predictions of an implosion of government indebtedness would prove wide of the mark. Such a move would be unequivocally positive for equities.

All these disparate factors – and there are more – make it difficult to come out with a single coherent strategy. It is rather like those rather silly competitions which one used to find on the back of cornflake packets: 'Put in order of attraction the following characteristics of Tupperware®: a) Tupperware® is strong, unbreakable and comes in many sizes, b) Tupperware® makes a family a go-ahead family, c) Tupperware® is hygienic and kills 99% of all known germs . . .' The point is that these characteristics cannot really be put in order, Tupperware®-style. Nevertheless, it is possible to balance off risks in a way which should establish that if we cannot be absolutely right, then we can avoid being absolutely wrong. The strategy is that of Napoleon marching on Moscow – to preserve sufficient forces to represent a military threat to the Russians. Let us hope that we do it better than him!

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