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## Investment Memorandum

In the end, the movements in international equity indices were unremarkable but they masked periods of significant volatility in markets and only a very strong rally at the end of the quarter prevented a negative quarter. In the circumstances, the performance of international equity markets most be considered to be very impressive. Bond markets were very mixed, performances being a function of the perceived creditworthiness of the borrower. The eurozone's plight benefited the US dollar and yen in the currency markets whilst gold ended the quarter little changed.

The tables below detail relevant movements in markets :

### International Equities 31.08.11 - 30.11.11

| Total Return Performances (%) |                |       |       |       |
|-------------------------------|----------------|-------|-------|-------|
| Country                       | Local Currency | £     | US\$  | €     |
| Australia                     | -2.7           | -3.4  | -6.7  | -0.2  |
| Finland                       | -2.3           | -5.4  | -8.6  | -2.3  |
| France                        | -3.3           | -6.4  | -9.5  | -3.3  |
| Germany                       | +4.5           | +1.1  | -2.3  | +4.5  |
| Hong Kong, China              | -13.8          | -10.6 | -13.6 | -7.6  |
| Italy                         | N/C            | -3.2  | -6.5  | N/C   |
| Japan                         | -4.6           | -2.7  | -6.0  | +0.5  |
| Netherlands                   | +1.6           | -1.7  | -5.0  | +1.6  |
| Spain                         | -1.3           | -4.5  | -7.7  | -1.3  |
| Switzerland                   | +2.2           | -6.2  | -9.4  | -3.1  |
| UK                            | +2.9           | +2.9  | -0.6  | +6.3  |
| USA                           | +2.8           | +6.4  | +2.8  | +10.0 |
| Europe ex UK                  | +0.4           | -4.0  | -7.2  | -0.8  |
| Asia Pacific ex Japan         | -5.1           | -5.8  | -9.0  | -2.7  |
| Asia Pacific                  | -4.9           | -4.5  | -7.7  | -1.3  |
| Latin America                 | +2.2           | -5.6  | -8.8  | -2.5  |
| All World All Emerging        | -3.2           | -7.0  | -10.2 | -4.0  |
| The World                     | +0.6           | +1.1  | -2.3  | +4.5  |

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +6.7%



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

| Currency       | 31.08.11 | 30.11.11 |
|----------------|----------|----------|
| Sterling       | 2.62     | 2.33     |
| US Dollar      | 2.22     | 2.06     |
| Yen            | 1.03     | 1.07     |
| Germany (Euro) | 2.25     | 2.28     |

### Sterling's performance during the quarter ending 30.11.11 (%)

| Currency          | Quarter Ending 30.11.11 |
|-------------------|-------------------------|
| US Dollar         | -3.5                    |
| Canadian Dollar   | +0.7                    |
| Yen               | -2.1                    |
| Euro              | +3.4                    |
| Swiss Franc       | +9.4                    |
| Australian dollar | +0.9                    |

### Other currency movements during the quarter ending 30.11.11 (%)

| Currency                  | Quarter Ending 30.11.11 |
|---------------------------|-------------------------|
| US Dollar/Canadian Dollar | +4.3                    |
| US Dollar/Yen             | +1.4                    |
| US Dollar/Euro            | +7.2                    |
| Swiss Franc/Euro          | -5.4                    |
| Euro/Yen                  | -5.4                    |

### Significant Commodities (US dollar terms) 31.08.11 - 30.11.11 (%)

| Currency | Quarter Ending 31.10.11 |
|----------|-------------------------|
| Oil      | -3.8                    |
| Gold     | -6.7                    |

### Markets

A very strong rally at the end of November rescued what was looking to be a poor quarter for equity investors. In the event, given the gravity of the international economic situation, the outcome for the quarter must be considered satisfactory. In local currency terms, the FTSE World Index returned +0.6%, in sterling terms +1.1%, in US dollar terms -2.3% and in euro terms +4.5%.

Looking at local currency returns first, the USA and UK markets performed relatively well with their relevant FTSE indices returning 2.8% and 2.9% respectively. There were no major deviations from the performance of the FTSE World Index with Japan and Asia Pacific ex Japan the weakest with their respective FTSE indices returning -4.6% and -5.1%. As so often, currency movements made a difference for sterling investors. The strength of the



US dollar meant that the FTSE USA Index returned 6.4% in sterling terms but turned a positive FTSE Europe ex UK index performance in local currency terms, +0.4%, into one of -4.0% in sterling terms.

We cover the position of sovereign bond markets later on in this review and the yields we show in our table relate to what are perceived to be the strongest credits. During the quarter, using ten year government bonds as a benchmark, we saw a 29 basis point fall in the gross redemption yield on ten year UK government bonds to 2.33% and one of 16 basis points to 2.06% on US Treasuries. On the other hand, there were slight increases of 4 basis points and 3 basis points in Japanese and German government bonds to 1.07% and 2.25% respectively. Towards the end of the quarter, we had the situation on occasions when the ten year UK government bond yield fell below that on the German government bond.

The turmoil in the eurozone meant that, in the currency markets, the US dollar and yen performed strongly whilst the euro and, particularly, the Swiss Franc weakened. Weakness in the Swiss Franc occurred because the Swiss Central Bank intervened to reverse the painful, for Swiss businesses, rise in the Swiss Franc by tying its value to that of the euro.

In the commodity markets, both oil and gold fall back modestly, by 3.8% and 6.7% respectively.

## **Economics**

Investors and investment managers are facing a set of circumstances without anything near an exact precedent. The task of investment is, therefore, particularly difficult because the element of subjectivity in decisions is much higher than usual. However, the circumstances of the present situation enable one to draw conclusions about the merits and demerits of different types of asset classes which can be justified on the basis of economic analysis and the probabilities/possibilities of certain scenarios developing.

Normally, in these economic reviews, we detail various items of economic data from around the world as we assess the outlook for particular countries or regions but, in the current circumstances, apart from a small amount of detail, it is the high level picture which is relevant. What we are facing at present is an existential crisis in a major currency union and this is a situation which the current generation of investors and investment managers has not faced. Currency unions have broken up before but the eurozone is a massive area and its break up was never envisaged by its founders and nor is there any formal mechanism for an exit. The economic costs of the stresses in the eurozone are becoming crippling not only for eurozone members but for non eurozone EU members like the UK and further afield. No country can fail to be affected although the degree will vary.

Our view, long and often expressed, is that the eurozone will fragment because it is not an optimal currency area. Eurozone leaders and those involved with the euro project will not admit this. It is probably a matter of pride that they will not admit this but, if this is the case, it comes at a very expensive price. It may be that, for them, the political aim of closer union trumps the economic angle. If so, this reason also comes with a very high cost. It may be that they think that the euro project is viable and not flawed. If so, the lack of understanding is frightening. It may be that they believe that the flaw in the project may give the opportunity to move to a fiscal union as well. Certainly, there is evidence to suggest that some people fall into this category.

In the first years of monetary union and until the 2008 financial crisis began to take root, there was not sufficient distinction between the creditworthiness of the different eurozone members. Very broadly, a sovereign liability of any eurozone member was regarded as of similar quality and this was consistent with the view that being a member of the eurozone would make eurozone members' economies converge. This was to be enforced by the Stability and Growth Pact, which was designed to enforce this convergence by limiting the size of budget deficits and outstanding public debt in relation to GDP. But with France and Germany breaking the rules early on, the



Pact became toothless and any disciplines which might have held monetary union together for longer were lost, leading to the present position. Apologists for the euro argue that the overall figures for the eurozone in relation to current account positions and outstanding public debt as a percentage of GDP are not too bad but this misses the point because there is no fiscal and transfer union. So those countries with large current account and budget deficits are now finding it difficult, if not impossible, to fund themselves and, if they are, in a limited way, like Spain and Italy, they are having to pay relatively very high rates of interest. Meanwhile, the fall in these countries' bond prices as interest rates rise, inflicts losses on bond holders.

Had these countries not joined the eurozone, conventional checks and balances would have come into play. Financial laxity would have been punished by currency weakness and higher interest rates. With its own central bank controlling the currency issue, such a country could have printed its own money however undesirable this would have been in normal circumstances. The country might have been forced to borrow from the International Monetary Fund which would have insisted on remedial measures being followed including, most probably, a devaluation over and above what might already have occurred. Whilst a devaluation may be a short term panacea, it carries with it the danger of elevated future inflation levels so IMF conditions would include a policy for dealing with such a danger. A devaluation should theoretically act as a stimulus to an economy by boosting exports and encouraging import substitution. The IMF, of course, recognises that economic growth is one way out of a country's debt problems.

However, let us compare the hypothetical position above with what is actually happening to those countries in the eurozone which are frozen out of the bond markets. Austerity is being forced upon them from the centre, with Germany, as the largest and most stable economy, calling the shots. Germany, with its historical aversion to inflation and espousal of fiscal rectitude, is horrified at what is going on in southern eurozone economies. Its default position in such cases is to call for measures to restore these countries' fiscal position, which involves austerity measures such as raising taxes and cutting public expenditure, both of which risk exacerbating the downwards spiral of the relevant economies and, therefore, the debt situation. The complacency induced by the introduction of the euro, with its "one size fits all" monetary policy and interest rates which were too low for many members, meant that inflationary pressures were not contained and these countries have lost significant competitiveness against Germany. This, under the convergence theory, was not meant to happen. Household and public debt ballooned as cheap money was, for a time, easily available, property bubbles appeared in countries like Ireland and Spain and it all seemed so easy. Everyone now knows differently, but the only way for these countries to restore their competitiveness levels against Germany, using that country as a benchmark, within a locked in currency regime is for there to be internal devaluations. This means cost cuts and strong deflationary measures, i.e. falling wages and, perhaps, pensions. We try not to stray into politics too much in these reviews but it seems self evident that, except perhaps in Ireland, the electorates will not stand for this and we can expect social unrest such as we have started to see, particularly in Greece. Although the economic issues are demanding attention, the political consequences are likely to be profound. Moves to "federalise" the economic management of the eurozone in response to one of the fundamental flaws in the euro, i.e. no fiscal or transfer union is likely to meet enormous popular resistance. Moves are in hand to have budgets of troubled eurozone countries pre-approved before being submitted to the relevant parliaments. This would appear to be a recipe for popular discontent and the ultimate appearance and support for politicians who will campaign for a departure from the euro, that is if markets have not got there first.

None of this is to exonerate the eurozone countries which currently find themselves in difficulties. Excessive government spending and deficit financing have been endemic. Labour and product markets have often been too rigid and, if something good comes out of this crisis, it could be that supply side reforms are made which increase



these countries' growth rate potential. These reforms have the advantage of costing nothing, important when no money is available. The benefits will be longer term, but will be undoubted if the reforms are implemented.

With seventeen eurozone members, managing the eurozone is analogous to running an organisation by a large committee. It rarely works and, in the case of the eurozone, there are different agendas. As a result, the politicians have consistently been behind events and have looked impotent. To observers with no vested interest in the eurozone, some of the politicians' and bureaucrats' comments have been extraordinary and show a weak grasp of the situation. One example, was the recent suggestion that rating agencies should be regulated. This was an example of trying to shoot the messenger rather than listening to the message. A second example, is the Franco German plan to introduce a financial transactions tax. It is admitted that it will reduce economic growth and cause businesses to move elsewhere. At times of crisis when all efforts should be being made to address the current mess, it beggars belief that France and Germany and others are actively seeking to promote a measure which will adversely affect the eurozone. It has the hallmarks of a classic diversionary tactic away from the politically inspired crisis which is the euro. Of course, banker bashing is very prevalent amongst populist politicians and it is very obvious why many voters are angry with the bankers, but it must be emphasised that the eurozone crisis is due to the flawed concept of monetary union operating with economies which are diverging. Because the Stability and Growth Pact was flouted early on in the life of the euro, the advent of the 2008 financial crisis and subsequent recession left many eurozone economies seriously exposed.

Germany is, of course, the economic powerhouse of the eurozone and is increasingly being regarded as the paymaster who calls the shots. But it is at loggerheads with many of the other stakeholders in the eurozone and this is causing mounting tensions. Because of its orthodox financial views, its belief is that wayward eurozone countries should follow an austerity path towards improving the state of their public finances. This threatens a downwards spiral for their economies, making debt targets difficult to achieve because their economies are contracting. Germany is reluctant to compromise its financial strength by supporting a eurozone eurobond, a much enlarged European Financial Stability Facility or an enlarged role for the ECB in buying eurozone debt. Germany is already guaranteeing almost 30% of the EFSF, around €30 billion, and all of these other ideas, in German eyes, extend the risks which the country is taking and, therefore, potentially increasing the credit risk of investing in Germany. Perhaps as a portent, as this is being written, a German bond auction has failed to be covered by 35%. The greater the potential liability a eurozone country runs by supporting these initiatives the weaker becomes its creditworthiness and this is the problem which confronts Germany. Additionally, the German Constitutional Court imposes strict limits on what Germany can do in relation to the eurozone and this is something which the German government has to consider. There is no doubt that, whilst the EU ideal is dear to the heart of many German politicians who would welcome a more federal EU, the German electorate is reluctant to bail out what it sees as feckless behaviour in some of the problem eurozone economies. The result is an impasse which is having a corrosive effect on the eurozone sovereign debt market. Apart from Greece, Ireland and Portugal, the original bailed out eurozone economies, Italy and Spain are now in serious danger as their ten year government bond yields hover around the 7% level and Belgium is now becoming another worry as its ten year government bond yield rises to around 5½%. Two more AAA rated countries, France and Austria, have seen their ten year government bonds' yields move to over 3.50%. Whilst that is not high in absolute terms, relative to Germany, where the current yield is about 2.25%, the gap is very wide for two AAA rated countries. France is at the low end of the AAA rated range, as this yield implies, but there are knock on effects. Price weakness in the EFSF bonds issued to bailout eurozone countries are now finding themselves under pressure because of concerns about the credit ratings of those countries like France giving the guarantees. With this type of problem, an attempted eurozone solution can infect the healthy core and Germany well recognises this.



Regulatory policy in the banking area has been predicated on sovereign bonds being riskless and, as events have shown, this is not the case. The latest plan for Greek sovereign debt indicates a voluntary 50% haircut, up from 21%. The eurozone governments and others are terrified of widespread haircuts because of the effect on the banking system. Many companies registered in eurozone countries are in a far healthier state than their governments.

Governance of the eurozone becomes more dysfunctional by the day and, as we have said in previous reviews, we believe that the only short term measure which can be taken to shore up the position until the future of the euro is decided, either in the markets or elsewhere, is for the ECB to monetise the debt. As we have suggested above, this would cause outrage in Germany and the Constitutional Court would almost certainly rule it unconstitutional but we see no option at present. A longer term prospect might, theoretically, be a fiscal union but we cannot see many electorates tolerating that idea. In any case, it could not happen time to deal with the current problem where time is now of the essence.

With the euro facing an existential crisis and some countries unable to fund themselves and having to be bailed out, we believe that the ECB will expand its balance sheet enormously by buying in eurozone sovereign debt of the troubled countries. It has been doing this activity, holding sovereign debt of the original three bailed out countries plus Italy and Spain. The inclusion of Italy and Spain raises the stakes to new levels, particularly Italy, which has the world's third largest volume of outstanding debt, around €1.9 trillion. The ECB is not allowed to fund countries directly so it could not buy new debt directly, but we believe that it will have to print money to buy troubled sovereign debt to try to keep yields down. This would be against everything the ECB stands for and would horrify Germany but when needs must the ECB cannot stand on ceremony. Such a move would weaken the creditworthiness of the stronger members of the eurozone but might stabilise the situation. One valid reason, we believe, for German opposition is that it might relieve the pressure on recalcitrant countries to reform themselves by removing moral hazard.

One vital function which the ECB is performing is to provide liquidity to the banking sector as the interbank market seizes up, with banks increasingly frightened to lend to each other and placing deposits with the ECB. Banks which have been starved of funds in the wholesale market have been increasingly borrowing from the ECB. The economic danger is for a credit crunch which will adversely affect economic activity.

The tragedy of this crisis is that it was all so unnecessary. Many warnings were given about the construction of the monetary union but they were ignored. The politicians ploughed on regardless and have landed the world economy with a manmade disaster which will reach out everywhere but, of course, particularly Europe. The UK, which wisely stayed out of the euro and therefore has more flexibility on interest rates, the exchange rate and the printing of money through quantitative easing, is still going to suffer from the euro's problems in terms of diminished economic activity.

Things are moving rapidly but, as this is written, our guess would be that the ECB will step into the breach, as we have just discussed, and the stakeholders in the eurozone will try to introduce a fiscal union, but the electorates of the countries will rebel against the austerity measures imposed on them because they will see no end to them. More governments may fall and there will arise a group of politicians who will want to leave the euro. This was never envisaged and it will be very messy and destabilising. The advantage of leaving will be in relation to the ability of the relevant countries to devalue and, if necessary, print money. Otherwise, to restore competitiveness through the internal devaluation route, mentioned earlier, will involve years of austerity and hardship and threaten the social and economic fabric of the country in question. Leaving is, we believe, the lesser of the two evils.

That we have come to the conclusion that the central bank will have to monetise some eurozone countries' debt by printing money to buy it and that this is the least bad solution to the eurozone's sovereign debt problem, is a





severe indictment of the policy mess. The fragmentation of the eurozone could be complete or partial but we do not see it lasting in its present state.

In normal times, the deadlock in the United States over the bipartisan congressional committee's failure to agree on a US\$1,200 billion deficit reduction package would be the main item of economic news, but the crisis in the eurozone transcends everything else of importance in economic terms at the moment, which shows just how serious the situation is in the eurozone. The USA is in a critical position as far as its public finances are concerned and the seeming lack of any will to agree a plan to put public finances on a path to some sort of order is hard for outsiders to understand. The situation at the top of US politics is poisonous with very little centre ground and both parties retreating to their activist supporters' position. It is basically an argument between big government with higher taxes against smaller government with lower taxes and the situation of both Democrats and Republicans is entrenched. Without any action, the outlook for the USA's public finances in the short, medium and long term is dire. The paradox is that, as our table at the beginning of this review shows, the US dollar has been a strong currency this quarter, this being a function of the euro's woes. The USA, like the UK, has the inestimable advantage of issuing its own currency and, if necessary, being able to print it whilst individual eurozone countries cannot do this. Providing Congress authorises the necessary rise in the debt ceiling for the USA, the USA can effectively print its way out of default although, of course, printing money debases the currency and can be expected to cause inflation later on. The USA has one major advantage over, say, the UK in that the US dollar is the world's largest reserve currency and therefore has to be held in large quantities by other countries in their foreign exchange reserves. Were they to dump part of their holdings (for most of them it would be impossible to sell the whole lot) they would be cutting off their nose to spite their face since it would devalue the rest of their holdings. So, the USA has an advantage and this gives it time but it does not alter the fact that the situation is very serious in the USA and, were it not for the eurozone's problems, attention would be focused on the USA.

The breakdown of talks on the US\$1,200 billion deficit reduction package threatens to end the payroll tax cuts and unemployment benefit help on 31 December 2011. The end of payroll tax cuts, if not extended, will provide a negative influence on economic activity. As things stand at the moment, it is possible that the tax cuts originating in George Bush's time as President, and due to end at the end of 2012, and the US\$1,200 billion in automatic spending cuts which have to be made as a result of the panel's failure to agree, could cause a contractionary effect on the US economy at a time when, at least in the west, economic conditions are very poor. As we have said in previous reviews, the USA's political system at times militates against sensible decision making with the checks and balances in place between both Houses of Congress and the Administration and, in the present situation, where there is a divided Congress and a poisonous attitude at the top of US politics, sensible decisions are impossible. If you compare this with the Westminster model of government, if the UK government can carry the House of Commons, say in terms of the programme it has put in place to eliminate the structural deficit, then that is a much more effective way of dealing with serious financial problems. The USA is going to have to tackle the problems that will arise from increasing entitlement benefits over the years and demographic challenges. The present situation is just not sustainable but the politicians are looking to the November 2012 elections rather than the longer term picture.

The US economy is performing better than the European ones. The latest reduced estimate of third quarter growth is 2.0% annualised which, whilst not as much as one would like to see, is still a relatively good number. The best we can say about the USA at the moment is that it is in a less bad situation than the eurozone and has certain advantages over it.

Turning now to the UK, as we have mentioned in the paragraph above, it has put in place plans to eliminate the structural deficit over the life of this parliament but that plan has been pushed back by economic weakness.





The EU is the UK's largest trading partner and it therefore is bound to be affected by the economic weakness in the eurozone arising from the sovereign debt crisis. As we can see from the table at the beginning of this review, the UK has been well rewarded for its robust approach to the elimination of the structural deficit in terms of being able to borrow at extraordinarily low rates of interest. This down payment on the UK's approach to public finances must not be destroyed by siren voices calling for the government to go more slowly in its deficit reduction programme. Such an approach is simply not credible, as can be seen from what has happened to eurozone countries which have lost the trust of investors. Interest rates on bonds have rocketed and, once confidence is lost, it is almost impossible for it to be recovered. Even if theoretically valid, there is no way in which markets would tolerate backsliding on the structural deficit elimination programme. It means that the UK coalition government is going to have a very testing time as the measures to restore public finances are bound to be very unpopular and industrial unrest, such as is being seen on 30th November, is likely to be a feature. But the alternative is worse. If interest rates were to rise sharply and the pound slump, the economic costs would be even greater. The USA has been able to see its bond yields fall to extraordinary low levels because of its position as the world's largest reserve currency and a haven in troubled times but the UK has no such advantage, although it does have the one of being able to issue its own currency, so a robust policy towards public finances is absolutely essential.

Of all the major countries, Japan is the most indebted, with gross public debt standing at over 200% of GDP. The country has made a quicker than unexpected recovery from the natural disasters of last March and, because it funds its deficit largely internally, it is not at risk from a loss of foreign confidence as has happened in the eurozone. Nevertheless, the demographics are very bad for Japan and it, too, will have to address its public debt problem but, for the moment, markets are not concentrating on that and Japan's problem has been to try to keep the yen competitive. It has intervened without much success in the foreign exchange markets.

As for China, its growth rate is one that the west can only dream of, even though the rate of economic growth is slowing down. China's immediate problem has been to restrain inflation, which was pushed up by very big increases in food prices, but this is now beginning to retreat and is now down to 5.5% year on year. China tightened its monetary policy substantially both by interest rate increases and by increasing bank reserve requirements and it is tentatively starting to rein back on the latter to stop the economy slowing down too much. China needs to grow quickly in order to absorb all the people coming in from rural areas and China is always afraid of issues which can cause social unrest. But China and other Asian countries, even though times are more difficult, are likely to grow fast enough to keep the world economy as a whole from moving into recession next year.

Because of what is happening in the eurozone, it is easy to forget that there are areas of the world which are performing reasonably well and their strength will help to limit the damage caused by the eurozone crisis. It is the reason for being positive, albeit for the prospects for many western multinational companies even if their home markets are subdued by the crisis. The OECD has just published its Economic Outlook No. 90. Economic forecasters are having to revise downwards their forecasts regularly now as the eurozone position worsens but, nevertheless, relative orders of magnitude are relevant. If we take the troubled euro area, the OECD now puts growth at 1.6% for 2011, 0.2% for 2012 and 1.4% for 2013. For next year, negative growth is forecast for Greece (-3.0%), Italy (-0.5%) and Portugal (-3.2%) showing just how difficult it is going to be to improve public finances when an economy is contracting. Even for Germany, the consequences of the eurozone's turmoil are reflected in expected growth of just 0.6% in 2012 and 1.9% in 2013 after 3.0% this year. A better outcome is expected from the USA with forecast growth rates of 1.7% for 2011, 2.0% for 2012 and 2.5% for 2013. The effect which the eurozone's difficulties are expected to have in the UK is shown by the respective forecasts of 0.9%, 0.5% and 1.8%. Natural disaster affected Japan is forecast to contract by 0.3% this year and then to grow by 2.0% next year and 1.6% in 2013. But some comfort can be drawn from the BRIC countries where the forecasts for 2011, 2012



and 2013 are respectively Brazil 3.4%, 3.2% and 3.9%, Russia 4.0%, 4.1% and 4.1%, India 7.7%, 7.2% and 8.2% and China 9.3%, 8.5% and 9.5%. If the eurozone implodes, these figures will, of course, be much worse, but, even in these grim times, it is important to keep some sense of perspective.

To summarise, it is difficult to overestimate the gravity of the present eurozone crisis. What we can say is that the creditworthiness of many sovereigns has been called into doubt and those which have benefited by default through a flight to perceived quality, i.e. the USA, UK and Germany, have government bonds which look extremely expensive with negative real yields in place. All three countries in different ways have scenarios where their bond yields could rise very sharply, inflicting severe losses on holders who had fled to them in pursuit of what were expected to be safer assets. Although many corporate borrowers are in a far stronger position than their countries of domicile, their yields will have to sell off their sovereign's debt. Many companies battened down the hatches after the 2008 financial crisis and have strong balance sheets giving credence to the idea that dividends may fare better than expected if the most pessimistic economic forecasts turn out to be correct. Indeed, the dividend experience has been quite good in 2011. Decent dividend yields, the possibility of dividend growth and some protection against inflation and very difficult home conditions make shares the asset class with the strongest case. Because shares are generally not highly rated at present, their default attraction, namely that bonds seen far riskier, is boosted. We have seen a volatile quarter and we must expect to see this continue as the news ebbs and flows but, counter intuitive as it may seem, exposure to good quality companies is likely to provide the best medium term returns.

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