meridian

ASSET MANAGEMENT (C.I.) LIMITED

# INVESTMENT MEMORANDUM

It has been another solid quarter for international equity markets with gains in almost all markets. Bonds, too, have performed well whilst, in the foreign exchange markets, sterling has shown all round strength. In the commodity markets, the oil price has weakened but gold improved over the quarter.

The tables below detail relevant movements in markets :

## International Equities 31.01.17 - 28.04.17

| Total Return Performances ( % ) | | | | |
|---|---|---|---|---|
| **Country** | **Local Currency** | **£** | **US$** | **€** |
| Australia | +7.3 | +2.8 | +5.7 | +4.9 |
| Finland | +14.0 | +11.7 | +14.9 | +14.0 |
| France | +11.7 | +9.5 | +12.6 | +11.7 |
| Germany | +7.8 | +5.6 | +8.6 | +7.8 |
| Hong Kong, China | +8.5 | +5.3 | +8.3 | +7.5 |
| Italy | +11.2 | +8.9 | +12.0 | +11.2 |
| Japan | +1.4 | -0.4 | +2.4 | +1.7 |
| Netherlands | +13.2 | +10.9 | +14.0 | +13.2 |
| Spain | +15.9 | +13.6 | +16.8 | +15.9 |
| Switzerland | +9.9 | +5.9 | +8.9 | +8.1 |
| UK | +3.2 | +3.2 | +6.1 | +5.3 |
| USA | +5.2 | +2.3 | +5.2 | +4.4 |
| Europe ex UK | +10.0 | +7.3 | +10.4 | +9.5 |
| All World Asia Pacific ex Japan | +7.1 | +5.1 | +8.1 | +7.3 |
| All World Asia Pacific | +4.7 | +2.8 | +5.7 | +4.9 |
| All World Latin America | +3.0 | +1.4 | +4.2 | +3.4 |
| All World All Emerging Markets | +5.5 | +4.4 | +7.4 | +6.6 |
| All World | +5.6 | +3.3 | +5.9 | +5.1 |

*Source FTSE World Indices*

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

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

| Currency | 31.01.17 | 28.04.17 |
|---|---|---|
| Sterling | 1.42 | 1.17 |
| US Dollar | 2.45 | 2.30 |
| Yen | 0.09 | 0.01 |
| Germany (Euro) | 0.44 | 0.34 |

## Sterling's performance during the quarter ending 28.04.17 (%)

| Currency | Quarter Ending 28.04.17 |
|---|---|
| US Dollar | +3.0 |
| Canadian Dollar | +7.9 |
| Yen | +1.6 |
| Euro | +1.9 |
| Swiss Franc | +3.3 |
| Australian Dollar | +4.3 |

## Other currency movements during the quarter ending 28.04.17 (%)

| Currency | Quarter Ending 28.04.17 |
|---|---|
| US Dollar / Canadian Dollar | +4.7 |
| US Dollar / Yen | -1.4 |
| US Dollar / Euro | -1.1 |
| Swiss Franc / Euro | -1.4 |
| Euro / Yen | -0.3 |

## Significant Commodities (US dollar terms) 31.01.17 - 28.04.17 (%)

| Currency | Quarter Ending 28.04.17 |
|---|---|
| Oil | -7.9 |
| Gold | +4.4 |

## MARKETS

It has been another solid quarter for international equity markets. In local currency terms, the FTSE All World Index has returned +5.6%, in sterling terms +3.3%, in US dollar terms +5.9% and, in euro terms, +5.1%. In local currency terms, all of the major markets showed a positive return. Europe ex UK was the stand out performer with the FTSE Europe ex UK Index returning +10.0%. Within that area, there were exceptionally good returns from the FTSE Spain Index (+15.9%), the FTSE Finland Index (+14.0%) and the FTSE Netherlands Index (+13.2%). The FTSE Japan Index (+1.4%) and the FTSE UK Index (+3.2%) both underperformed. In sterling terms, the pattern changes somewhat. The FTSE Europe ex UK Index was still the strongest performer, returning +7.3% in sterling terms and the FTSE UK Index became an above average performer with its return of +3.2%. Emerging Markets also outperformed with the FTSE All World All Emerging Markets Index returning +4.4%. The USA was a marginal underperformer with the FTSE USA Index returning +2.3%. The only negative performance, and only a slight one at that, in the whole table was the sterling adjusted FTSE Japan Index which returned -0.4%.

International bond markets also had a very solid quarter. Taking ten year government bond yields as a benchmark, the gross redemption yield on the UK gilt fell by 25 basis points to 1.17%, on the US Treasury by 15 basis points to 2.30%, on the Japanese Government Bond by 8 basis points to 0.01% and on the German Bund by 10 basis points to 0.34%.

In the foreign exchange markets, sterling had a strong quarter. Against a very weak Canadian dollar, sterling rose by 7.9%, against the Australian dollar by 4.3%, against the Swiss Franc by 3.3%, against the US dollar by 3.0%, against the euro by 1.9% and against the yen by 1.6%.

In the commodities markets, oil fell back by 7.9% as there were increasing doubts about the ability of OPEC to support the oil price, but gold rose by 4.4%.

## ECONOMICS

April has been an eventful month on the political scene. We have seen Theresa May's surprise announcement of a General Election on the 8th June although, in retrospect, it seems extremely logical from the UK government's point of view to call one then and we have had the result of the first round of the French Presidential election. The opinion polls correctly forecast the result of the latter and, as this is written, the European stock markets have moved quite sharply higher in the expectation that Emmanuel Macron, rather than a more extreme candidate, will become the next French President. On present evidence from UK opinion polls, the Conservatives are expected to be returned with a larger majority. The short term effect in the UK has been a strengthening of sterling. Elsewhere, the main international focus in the political scene, apart from the uncertainty about the course of US policy, has been the standoff with North Korea, potentially a very worrying development in view of its potential nuclear capability, notwithstanding the failure of some of its rocket launches.

However, on the economic front, there is some good news, at least for the moment. Economic growth appears to be accelerating, not rapidly, but giving some hope that the effects of the financial crises are beginning to wear off. The IMF has just published its latest economic projections in its World Economic Outlook and they show a slight uplift from last January. Its projection of growth in 2017 has been increased very slightly by 0.1% to 3.5%, whilst it has left its 2018 figure at 3.6%. In the Advanced Economies sector, it has raised this year's projection by 0.1% to 2.0%, again leaving its 2018 projection unchanged at 2.0%. Within the Advanced Economies section, it has not made any changes to its 2017 forecast for the USA, which remains at 2.3%, and its forecast for 2018 is also unchanged at 2.5%. However, in line with anecdotal evidence from recent data, it is unsurprising that it has lifted its projection for the eurozone by 0.1% to 1.7% for this year, although it has left 2018's projection at 1.6%. Within 2017's eurozone projections, it has raised those for Germany, France and Italy by 0.1% in each case to 1.6%, 1.4% at 0.8% respectively. The largest increase is for Spain where the 2017 forecast has been raised by 0.3% to 2.6% and left unchanged at 2.1% for 2018. There has been a substantial uplift in the projection for Japan by 0.4% to 1.2% for this year and an increase of 0.1% next year to 0.6%. The most striking upgrade is for the UK which is now forecast to grow by 2.0% in 2017 and 1.5% in 2018, increases from last January of 0.5% and 0.1% respectively. There is no change in the projected growth levels for Canada at 1.9% and 2.0% respectively. Emerging Market and Developing Economies' projections for this year and next are left unchanged at 4.5% and 4.8% respectively. Amongst the BRIC economies, the most significant change is for Russia whose forecast growth for 2017 has been upgraded by 0.3% to 1.4% and by 0.2% for 2018 to 1.4% also. There has been a slight increase in projected growth for China, by 0.1% for 2017 to 6.6% and by 0.2% for 2018 to 6.2%. There is no change in the forecasts for India at 7.2% and 7.7% respectively. For Brazil, this year's forecast is unchanged at 0.2% but it has been raised by 0.2% to 1.7% for 2018. There has been an uptick in the IMF's inflation forecasts for this year, by 0.3% in Advanced Economies to 2.0% and by 0.2% in Emerging Market and Developing Economies to 4.7%. 2018's forecasts remain unchanged at 1.9% for Advanced Economies and 4.4% for Emerging Market and Developing Economies. As always, there are many uncertainties, some of which we will discuss as we review the main areas of the world economy, starting with the USA.

Of the G7 economies, the USA is expected to perform best of all in 2017 and 2018, according to the IMF's projections. The Federal Reserve feels confident enough to start raising interest rates and there have so far been two in this cycle to take the target range to 0.75% to 1.00% with more expected during the course of the year, reflecting the relative strength of the employment market and increased, but still low, inflation as well as solid economic growth. In this context, the lower than expected 0.7% annualised first quarter growth rate is not likely to reflect second quarter GDP. Amongst relevant economic indicators, the Purchasing Managers Indices have been quite strong and these are regarded as important signals of economic activity. The latest PMI for manufacturing stands at 54.8 and that for non manufacturing at 57.5. Although the latest non farm payroll figures were lower than expected at 98,000 new jobs, it followed a number of previously strong readings. The unemployment rate has fallen from 4.8% in January to 4.5% in March and the labour force participation rate has risen slowly to 63%. The unemployment figures must always be considered in conjunction with the labour force participation rate which is quite low but improving. A low labour force participation rate can give a flatteringly low unemployment rate. Durable goods orders have been quite strong, up almost 5% year on year, and the capacity utilisation level for the industrial sector has crept up to 76.1%, 3.8% below its 1972-2016 average. Consumer confidence, as evidenced by the University of Michigan's Consumer Confidence Index, has also been quite strong with the index of consumer sentiment standing at 98.0, 10.1% higher than a year previously. Its index of current economic conditions stands at 115.2, 8.0% up on a year previously, whilst the index of consumer expectations stands at 86.9, 12.0% higher than a year previously. Industrial production figures have been creeping up with the index standing at 104.1, 1.5% higher than twelve months previously. The Personal Consumption Expenditure Core Price Index, favoured by the Federal Reserve, stands at about 1.75% which puts into perspective a federal funds target rate of 0.75% to 1.0%. Even though inflation is historically low, these are not the levels of interest rate which one would normally associate with this level of inflation. The year on year consumer price index is 2.4%. Add to this, and very important given how much US equity prices have risen, corporate earnings are on the turn with some estimates for them to have been about 9.2% higher in the first quarter of 2017 compared with a year previously.

In normal circumstances, the economic data would be the most important driver of investment policy mixed in with valuation levels, but we now have to factor in the economic policy of the new US Administration and this is where it becomes difficult because of the uncertainty. There were three issues which excited investors following President Trump's election, tax cuts, deregulation and infrastructure spending. These were generally regarded as positive for markets but there was one potentially large negative threat which was protectionism.

Of the three potentially positive factors, deregulation, if it occurs in a meaningful way, is welcome. The burden of regulation in recent years has increased substantially and it inflicts a heavy cost on business and, therefore, the economy. It is also relatively costless to deregulate, although not everyone would feel that way. Investors like the idea of tax cuts both personal and corporate. However, there are two issues for the USA. As we have shown above, the US economy is performing quite well. In these circumstances, adding a pro cyclical tax cut on top of a growing economy risks overheating it and causing inflation. If the economy was contracting, adding a pro cyclical automatic stabiliser would be sensible economics but not when the economy is expanding quite well. If the tax cuts were balanced by an equivalent cut in federal spending, that would be another matter, but the Administration appears to be having difficulty finding the spending reductions. In principle, infrastructure spending is good because it should increase the long term potential growth of an economy but, again, it has to be financed, this is assuming that we are talking about public sector infrastructure spending. Again, if this leads to increased government borrowing, besides helping to overheat the economy and cause inflationary pressures, an increased federal deficit would be likely to put upward pressure on interest rates. So, whilst these three potentially positive supply side policies can be broadly welcomed, the stage of the US economic cycle at which we are and the financing of the tax cuts and infrastructure spending plans, must qualify one's enthusiasm because of the potentially negative economic consequences. But one can quite unequivocally condemn protectionism and this is the most worrying aspect of President Trump's pre-election rhetoric. It undoubtedly helped him to win the election, as results in states like Pennsylvania, Michigan and Wisconsin show, but imposing tariffs and quotas, two protectionist policies, is bad economics. Whilst some people will benefit in industries which have faced foreign competition, consumers would lose out by paying more for goods, meaning that their spending power is reduced to the detriment of jobs in the affected markets. If tariffs have the effect of reducing the trade deficit, the US dollar may rise thus helping to offset the negative effect of tariffs. This would make US exports less competitive, thereby threatening jobs in export orientated businesses and the rise in the US dollar could offset whatever tariff levels are set. If a trade war ensued, economic activity in the world economy would be reduced causing unemployment to increase and governments to have to borrow more. Protectionism is a thoroughly bad policy and it is to be hoped that wiser counsels prevail. We have mentioned before in these reviews that the checks and balances in the US Constitution provide some comfort in restraining the powers of the President. We have already seen that some Republicans in Congress stymied the President's plans to reform Obamacare. There are some able people around the President and we are already seeing some rowing back on some of his pre-election pronouncements. For example, China will not be called out as a currency manipulator which is encouraging. President Trump is on a steep learning curve and we therefore think that it is premature to take a negative view of the Administration's economic policies, as we prefer to judge actions rather than words. The US equity market is just below its all time high as this is written and we consider it important that US corporate earnings rise this year to validate the share price rises which have already occurred. If that happens, and we think it will at this stage, then our confidence in this market will be maintained.

Turning to the eurozone, we have noted that the IMF has slightly raised its forecast for economic growth this year on the back of some more encouraging economic indicators. The recent Purchasing Managers Indices have been strong. The latest composite index stands at 56.8, that for services at 56.4 and that for manufacturing at 56.7. It is encouraging that the figures for the two largest economies are strong, particularly in the case of France where there have previously been some weaker figures. The latest PMI for German manufacturing was 58.2 and that for services at 55.4, whilst the respective figures for France are 55.1 and 56.7. Whilst still very high compared with the USA and UK, unemployment has been trending downwards in the eurozone with the latest level being 9.5%. This is still far too high but it is not as bad as it was. However, the eurozone countries' growth rates, which are generally still too low to make a dent in heavily indebted countries' overall public debt ratios to

GDP, have been supported by the ECB's asset purchases which had been running at €80 billion per month, now reduced to €60 billion and expected to remain at that level until the end of the year with uncertainty about the ECB's actions after that time. If it takes this amount of asset buying to support what is a fairly modest level of economic growth, the underlying weakness of the overall eurozone economy is evident. The expansion of the ECB's balance sheet cannot continue indefinitely. It is highly dangerous and risks big losses. The question is, however, what happens when it stops buying bonds? Heavily indebted countries like Italy will lose a buyer of their debt in the secondary market and the risk will have to be priced more realistically in the markets. Will there be sufficient buyers of new debt without support in the secondary market? It is illegal for the ECB to finance directly eurozone countries' borrowings in the primary market. Turning from the macro level to the micro level, the state of the EU's banking system remains a concern with over €1 trillion of non performing loans. Italy is a particular case in point with Italian banks holding a large number of non performing bank loans amounting to €276 billion. How this is going to be resolved within EU rules is a major issue but a weakened banking system is unable to provide sufficient funds to businesses and this limits an economy's growth prospects. No one should become complacent about the eurozone because short term growth prospects have improved. Monetary policy has been pushed to the limit to support what is still a relatively low growth rate. Exiting from this very loose and unorthodox monetary policy is a necessity at some stage and that process will provide a list of challenges against a background of high levels of debt in certain eurozone countries. Whilst the probable election of Emmanuel Macron to the Presidency in France has been greeted with relief, it must be remembered that he is an independent and has no party in the Assembly and will have to work with other parties after the June Assembly elections. France desperately needs major structural reforms if it is to flourish and resistance to change is a matter of historical fact in France. Emmanuel Macron has put himself forward as a reformer but, if he does become President, he will face strong vested interests opposing him. Given France's importance in the eurozone as the second largest economy, the course of events in that country will require careful monitoring by investors. However, as we always say, it is important for equity investors in particular to distinguish between companies based in the eurozone and their sovereigns. It is still possible to earn acceptable returns in good quality companies even if the economic background for the countries in which they are based is difficult.

Whilst the USA and eurozone are clearly high profile for investors, Japan, although the third largest economy and second largest stock market, has a much lower profile and events there are unlikely to be a major area of concern for investors. Whilst government debt is very high as a percentage of GDP at about 248% gross and 126% net, most of it is held internally, it is unlikely to cause the same concerns as in the eurozone. The Bank of Japan continues with its vast quantitative easing programme which, as in the eurozone, is unsustainable on any long term basis given how it has blown up the Bank of Japan's balance sheet and the risks which this causes. As we saw at the beginning of this review, the IMF has raised its growth forecast quite significantly for Japan this year and a little next year but the expected growth rates still remain very low. The economic data has been consistent with an improved forecast for economic growth. Industrial production is 3.3% higher than a year earlier, the Purchasing Managers Indices have consistently been above 50 with the latest composite index standing at 52.6, reflecting a positon of modest expansion. Consumer confidence has been gradually improving and the month on month figures for retail sales show modest rises. The unemployment rate has fallen to 2.8%. Very importantly for the government and the Bank of Japan, inflation on a year on year basis has turned positive, even if only at 0.2%. The reason why this is so important for the government and the Bank of Japan is that it may encourage consumers to spend if they can change their mindset from one where it is worth deferring unnecessary spending in the belief that prices will move lower to one where money may be saved by buying now because purchases will be more expensive later. The same principle would apply to businesses. Japan faces huge challenges arising from its very unfavourable demographics, one of which will be controlling its already very high ratio of public debt to GDP since the worsening demographics put increasing pressure on public finances. The best way for any country to make inroads into its public debts is through economic growth. In a deflationary environment, the real value of debts increases, and vice versa in an inflationary environment. So, there are some encouraging signs on the economic front but it is very early days.

In Asia, of course, the key economy as far as many investors are concerned is China whose economic data is watched closely. A slower rate of economic growth is to be expected as the country makes its economic transformation towards a more consumer based and service orientated economy away from excessive fixed asset investment and exports. This should, if it is successfully achieved, make growth more sustainable. The latest year on year GDP growth to the end of March was 6.9%, slightly higher than the 6.8% figure for the previous quarter. The latest quarter on quarter annualised growth rate was 5.3%, reflecting the March quarter on quarter growth rate of 1.3%. The latest year on year industrial production figures showed growth of 7.6%, up from 6.3% in February. The important purchasing managers indices have remained fairly stable above 50. The latest index for manufacturing is 51.2 and for non manufacturing 54.0. Retail sales show a year on year growth of 10.9%. China runs a substantial current account surplus, forecast to be around 1.7% of GDP in 2017, and yet there have been substantial capital outflows from the country which have caused the authorities to put some quantitative controls on investment overseas. There has also been intervention to support the Chinese currency which would also account for the fall in foreign exchange reserves. These have recovered slightly in February and March to US$3.009 trillion against a peak of around US$4 trillion in 2014. This, of course, makes it very difficult for the USA to define China as a currency manipulator even though the currency has fallen quite significantly against the US dollar over the past year by around 6%. At the moment, data from China is not causing too many jitters but it needs monitoring, perhaps especially in relation to movements in the country's foreign exchange reserves and what this may tell us.

This leads on to the position of emerging markets generally in the light of potential threats arising from a trade war as a result of any protectionist policies which the USA may introduce. This would not be good news for the world economy generally and for emerging markets in particular. Trade would slow down and there would be a significant possibility of a recession or even worse. Although exchange rate movements are difficult to forecast, the likelihood in these circumstances is that the US dollar would rise posing particular problems for emerging markets, a lot of whose debt is denominated in US dollars. Such a position would make repayment of principal and servicing costs of the debt more difficult and would lead to a capital flight from the relevant countries thus reducing the available funds for businesses and individuals. The performance of emerging markets' securities at present suggests that this is not viewed as a serious risk by investors but all will depend upon the course of US economic policy. The importance of this is shown by recent data from the Institute of International Finance. It reported that total emerging market debt stood at US$55 trillion at the end of 2016 which represented 215% of total emerging market GDP. In 2006, the figure was US$16 trillion and in 1996, US$7.4 trillion. A fifth of bonds and loans of US$1.1 trillion due to mature this year are estimated to be denominated in US dollars. The IIF estimated that total local currency debt in emerging markets in 2016 amounted to US$48.5 trillion whilst foreign currency debt stood at US$7.2 trillion.

The major news in the UK has, of course, been the calling of an early General Election, just two years after the previous one. Before the 2015 General Election there was great uncertainty about the result and we felt that the risks for the stock market of an indecisive result, which the opinion polls had indicated to be the case, were high. In the event, the opinion polls' forecasts were inaccurate. Whilst nothing is certain, the opinion polls would have to be inaccurate by an unprecedented magnitude on this occasion to suggest anything other than a Conservative victory by a larger amount than in 2015. We should know more after the local elections on the 4th May for, whilst not necessarily mirroring the results of the General Election the next month, should give a pointer to the general thrust of voters' intentions. Notwithstanding that the Brexit negotiations have not yet started and are bound to be difficult, the fact that there will probably not have to be a General Election again before 2022 will give more stability as the government will not be so pressurised towards the end of the negotiations, when a General Election would have been approaching as it would have been due in 2020 under the Fixed Term Parliaments Act. That could have been a particularly uncertain and difficult time for markets. This is looking a long way ahead and a lot of things can happen meanwhile, but it could remove some medium term uncertainties for investors in the UK securities markets. There are a few things we can say about the UK economy, however. It has not fallen off a cliff after the EU referendum vote. In 2016, together with Germany, the UK showed the fastest growth rate at 1.8%, although, of course, only half the year reflected any Brexit decisions on spending and investment. If the IMF's projections for 2017 are correct in its latest World Economic Outlook, only the USA will grow faster. According to the IMF, the UK will lose ground next year, coming fourth equal after the USA, Canada and France. However, we should remember that nearly all forecasters were wrong in their post referendum forecasts for the UK economy, which has stood up well to the Brexit vote. On the negative side, the effects of sterling's post referendum depreciation can be seen in rising inflation which will squeeze disposable incomes. Consumers have been drawing down their savings but one can see that the squeeze will affect economic activity which is why economists expect some slowdown in the UK economy. On the other hand, exports are pointing up as one would expect after a currency's devaluation. Manufacturing represents only about 10% of GDP but, at the margin, rising exports will be a positive driver for the UK economy. The purchasing managers indices are quite strong. The latest composite index stands at 56.2, that for manufacturing at 57.3 and for services at 55.8. Unemployment at 4.7% represents continuing strength in the employment market. There have been some weak spots with the latest month on month figures for industrial production and manufacturing both lower, although the year on year figures are up 2.8% and 3.3% respectively. Retail sales figures have been erratic but weaker. However, compared with what those who feared that Brexit would lead to immediate economic weakness foresaw, the overall outcome at this early stage for the UK economy has been benign but it is realistic to expect some slowing as the IMF's projections show.

The international economic background is supportive to our continuing view that equities remain the most suitable asset class in which to be invested. They should obtain support from the improved corporate earnings outlook and further increases in dividends in many markets. We rate this latter factor very important at a time when common sense, notwithstanding some central banks' support for bonds, tells us that bond yields remain very unattractive. In most markets, with the USA being an exception, equity dividend yields remain above ten year bond yields and dividends are growing. The challenge for equities will come when central banks start to reverse their accommodation, say by selling back bonds they have accumulated to the private sector thereby sucking the money back out of the economy. This can be expected to send interest rates higher. Early rises in interest rates, such as we have started to see in the USA and which reflect better economic conditions, should not challenge equities given their relative, if not absolute, yield advantage.

After markets have risen so much and so consistently for some time, it is almost inevitable that we will see some quarterly setbacks. There is still much to worry about in the world's political and economic background. Markets have shown themselves to be quite resilient in the face of some negative factors and there is always a reason to be out of the market, but long term investors do best by staying in the market. Should markets have a significant setback, we will use any accumulated cash to raise our equity positions.