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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

For sterling based investors, a weak quarter for international equities has been softened by sterling's weakness, reversing a previous stronger trend for the currency. After a promising start to the year, a sharp increase in market volatility in February unsettled investors. Bond markets were notable for the yield on the ten year US Treasury bond breaking through 3% towards the end of April, although it subsequently came off that peak. Currency markets were notable for the recovery in the US dollar after a period of weakness. In the commodity markets, oil continued to strengthen.

The tables below detail relevant movements in markets :

International Equities 31.01.18 - 30.04.18

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+0.3	-3.4	-6.5	-3.6
Finland	+9.0	+9.1	+5.7	+9.0
France	+1.4	+1.5	-1.7	+1.4
Germany	-3.9	-3.7	-6.8	-3.9
Hong Kong, China	-2.8	N/C	-3.2	-0.1
Italy	+2.9	+3.0	-0.2	+2.9
Japan	-2.4	+0.5	-2.7	+0.4
Netherlands	-0.5	-0.3	-3.5	-0.5
Spain	-4.3	-4.1	-7.1	-4.3
Switzerland	-1.9	-4.9	-7.8	-5.0
UK	+1.1	+1.1	-2.1	+0.9
USA	-5.7	-2.6	-5.7	-2.8
All World Europe ex UK	-1.4	-2.2	-5.3	-2.3
All World Asia Pacific ex Japan	-3.9	-2.9	-5.9	-3.0
All World Asia Pacific	-3.3	-1.5	-4.6	-1.7
All World Latin America	N/C	-3.0	-6.0	-3.1
All World All Emerging Markets	-5.2	-4.6	-7.6	-4.8
All World	-3.9	-2.1	-5.2	-2.3

Source FTSE World Indices

FTSE Actuaries UK Conventional Gilts All Stocks Index (total return): +1.3%

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

Currency	31.01.18	30.04.18
Sterling	1.49	1.48
US Dollar	2.73	2.96
Yen	0.08	0.04
Germany (Euro)	0.63	0.50

Sterling's performance during the quarter ending 30.04.18 (%)

Currency	Quarter Ending 30.04.18
US Dollar	-3.0
Canadian Dollar	+1.0
Yen	-3.2
Euro	-0.4
Swiss Franc	+2.9
Australian Dollar	+3.6

Other currency movements during the quarter ending 30.04.18 (%)

Currency	Quarter Ending 30.04.18
US Dollar / Canadian Dollar	+4.1
US Dollar / Yen	-0.2
US Dollar / Euro	+2.6
Swiss Franc / Euro	-3.3
Euro / Yen	-2.7

Significant Commodities (US dollar terms) 31.01.18 - 30.04.18 (%)

Currency	Quarter Ending 30.04.18
Oil	+9.2
Gold	-1.8

MARKETS

In an eventful quarter for international equity markets, most markets ended weaker but the setback was modest against the gains of recent years. In total return terms, the FTSE All World Index returned -3.9% in local currency terms, -2.1% in sterling terms, -5.2% in US dollar terms and -2.3% in euro terms. Looking at local currency returns first, there were positive returns from the UK with the FTSE UK Index returning +1.1%, the FTSE Australia Index +0.3% and, within Europe, the FTSE France Index returned +1.4%, the FTSE Italy Index +2.9% and the FTSE Finland Index +9.0%. On the other hand, there were below average returns from the FTSE USA Index, -5.7%, and the FTSE All World All Emerging Markets Index, -5.2%. In sterling terms, the most noticeable difference was that the weakness of the Australian dollar pushed the return on the FTSE Australia Index into negative territory, -3.4%, whilst the return on the FTSE USA Index at -2.6% was only a little below the -2.1% total return on the FTSE All World Index. The return of the FTSE Japan Index moved from -2.4% in local currency terms to +0.5% in sterling terms.

In the international bond markets, and taking ten year government bonds as the benchmark, there was hardly any change in the gross redemption yield on the UK gilt with the yield dropping by just 1 basis point to 1.48%. On the US Treasury, the yield jumped by 23 basis points to 2.96%. The yield on the Japanese Government Bond, which the Bank of Japan aims to keep at around zero, fell by 4 basis points to 0.04%. On the German Bund, the yield fell by 13 basis points to 0.50%. We will be writing more fully about the bond market in our review.

In the currency markets, there was a partial reversal of sterling's recent strength. Against the yen it fell by 3.2%, against the US dollar by 3.0% and against the euro by 0.4%. However, it strengthened against the Australian dollar by 3.6%, against the Swiss Franc by 2.9% and against the Canadian dollar by 1.0%.

In the commodity markets, oil rose by 9.2% as OPEC supply constraints, amongst other factors, continued to support prices. Gold slipped slightly by 1.8%.

ECONOMICS

Although there is some evidence of weakening economic momentum, it is far too early to call an end to a period of synchronised economic growth. The pause may only be temporary. The IMF has just produced its latest economic projections in its April World Economic Outlook and, although it is more cautious about prospects later on, its forecasts for 2018 and 2019 are for quite strong growth at 3.9%, unchanged from its January projections. This compares with growth of 3.8% in 2017. The IMF has slightly raised its forecast for growth in Advanced Economies this year by 0.2% to 2.5% and left its forecast for next year unchanged at 2.2%. Within this figure, the forecast for the USA has been raised by 0.2% for both years to 2.9% for 2018 and 2.7% in 2019 following the tax cuts package and fiscal stimulus announced earlier this year. The forecast for the eurozone has been raised by 0.2% for this year to 2.4% but left unchanged for next year at 2.0%. Within the eurozone, Germany's economic growth forecast for this year has been raised by 0.2% to 2.5% but left unchanged for next year at 2.0%. Similarly, France's growth forecast for this year has been raised by 0.2% to 2.1% and raised by 0.1% to 2.0% next year. There has been a slight increase in the forecast for Italy this year by 0.1% to 1.5%, although no change for next year at 1.1%. Spain has seen a large jump in the forecast this year. The

IMF now sees 2018 growth 0.4% higher at 2.8% and 0.1% higher in 2019 at 2.2%. The IMF has left its forecasts for Japan unchanged for both years at 1.2% and 0.9% respectively. The UK has seen its forecast for 2018 raised slightly to 1.6%, although that for 2019 remains unchanged at 1.5%. The only G7 economy to see a reduction in its growth forecast for 2018 was Canada. The IMF now sees growth 0.2% lower than it did in January at 2.1%, although the forecast for 2019 was left unchanged at 2.0%. For Emerging Market and Developing Economies, the IMF did not adjust its forecast for 2018. It remained at 4.9% although, for 2019, it was raised by 0.1% to 5.1%. The forecasts for China and India were left unchanged for both years, China at 6.6% and 6.4% and India at 7.4% and 7.8%. There was, however, a sharp rise in the IMF's expectations for Brazil with increased projections for both 2018 and 2019 of 0.4% each year at 2.3% and 2.5% respectively. In terms of inflation, the IMF does not see much change from its January projections, just a 0.1% increase in 2018 for both Advanced Economies and Emerging Market and Developing Economies to 2.0% and 4.6% respectively for 2018, and 1.9% and 4.3% respectively for 2019, a decrease of 0.2% for Advanced Economies and unchanged for Emerging Market and Developing Economies.

With this economic background of satisfactory growth and modest inflation, the background should be supportive of equities, with a satisfactory rate of corporate earnings growth in most countries and regions. For example, in the USA, Factset reports that companies are reporting earnings growth of 18.3% for Q1 2018 and revenue growth of 7.8% year on year. For Q2, it says that analysts are projecting figures of 19.0% and 7.8%, for Q3 21.0% and 6.5% and for Q4 16.9% and 5.7%. For 2018 as a whole, analysts are projecting earnings growth of 18.5% and revenue growth of 6.8%. Of course, these figures are given a one off boost by the US corporate tax cuts announced at the beginning of the year. There are various estimates about the effect on corporate earnings but, at the lowest level, a one off earnings boost of 7% has been suggested. This rate of growth is higher than in most other countries because of this tax cut but the trend is upwards almost everywhere.

Whilst this is an encouraging picture, especially as economic growth seems well synchronised, as always it is necessary to consider political and economic aspects of the current background to obtain a full view of the issues which could affect stock markets. On the political front, one of the main concerns earlier this year was the North Korea situation. Our view then, and this still remains the case, is that a nuclear conflagration would be so devastating that it could not be factored into investment policy. On the other hand, present economic developments, for example on the interest rate front, can be factored into one's investment policy. At the moment, possibly because of Chinese pressure on North Korea, the outlook is much more encouraging as the leaders of South Korea and North Korea meet and commit to denuclearisation. The chemical attacks in Syria and the military reaction of the USA, UK and France to those attacks, plus the spectre of Russia's involvement in the area, make for a very unpredictable situation. For the world economy, the enmities between the various countries in the Middle East, which could burst into the open and affect oil supplies, always pose a threat and, notwithstanding a rise in US oil production as a result of fracking, still leave the world economy vulnerable to an oil price shock. So far, however, it would be fair to say that political events, however threatening they might be, have not greatly influenced markets.

But, what of the economics? Markets had started the year well until early February when, what turned out to be too high an estimate for US average hourly earnings growth at 2.9% (it was subsequently revised down to 2.8%) spooked the market as it raised interest rate expectations. Until then, markets had been on an upward progression with low volatility. A short volatility exchange traded note, which investors held on the basis of low volatility continuing, then imploded as volatility increased and these two events caused significant volatility in the markets which took some time to die down and volatility remains at more elevated levels than in the early part of the year. The main economic issue has to be the threatened trade war between the USA and China which could cause collateral damage. Although there had been tariff moves earlier this year on items like washing machines and solar panels which affected China, the imposition by President Trump of tariffs on steel and aluminum of 25% and 10% respectively sparked off threats of tit for tat by the Chinese government. This would be negative for the world economy if it were to get out of hand. The initial skirmishes are not considered too serious

in terms of their effect on economic growth but, if the list expands on both sides, as it threatens to, the outcome will not be good. We have to hope that wiser counsels prevail. Optimists could cite President Trump's threats to North Korea as a reason why that country might come to the negotiating table and also recent announcements by China about more economic liberalisation, for example by allowing foreign companies to acquire majority stakes in Chinese banks and securities firms (first announced in November) and reducing tariffs on imported cars. The pessimists would say that President Trump is a protectionist at heart and the movement of trade and tariffs to one of the top items on his political agenda, after seeming to be sidelined last year, is in line with his economic thinking. The issues between the two countries, for example the USA's complaints about the loss of its intellectual property to China, are difficult to solve and we are seeing the USA taking a much harder line on Chinese acquisitions of US companies. Protectionism is generally a bad economic policy as it distorts markets and reduces consumers' welfare. For example, the tariffs on Chinese steel will benefit a relatively small number of people who work in the US steel industry but will raise the price of imported steel used in US manufacturing and therefore raise the price of finished goods bought by US consumers, leaving them with less money to buy other goods and services, some of which will be provided by US companies which will suffer as a result. To say that a trade war provides easy wins, even if it is with a country with which the USA has a large trade deficit, is wrong. There are valid issues on both sides in this trade dispute and an optimist will hope that this ramp up in tensions brings both sides to the negotiating table. One has to be a realist because President Trump is a protectionist and President Xi is very determined to promote China's economic power.

Whilst the IMF's growth projections for the next two years are quite positive, its view is more cautious beyond that. As output gaps (the difference between what could be produced and what actually is produced) narrow, it thinks that growth will slip back. It also references a possible tightening of financial conditions and growing trade tensions amongst other factors. It is against this background that it is worth looking at the bond markets which are demonstrating some strange characteristics.

If we take the US bond market, at the time this review is being written, the 2 year Treasury bond is yielding 2.480%, the 10 year bond 2.963% and the 30 year bond 3.136%. In other words, the yield curve is pretty flat. One can understand why the 2 year bond yield is where it is because we know that the Federal Reserve is almost certain to raise interest rates at least twice more this year and the federal funds target rate is currently 1.50% - 1.75%, so two more rises, assuming it raises rates 0.25% each time, would take the target range to 2.00% - 2.25%. Normally, one would expect there to be a significant difference between 2 year, 10 year and 30 year yields but, as we can see above, it is very small especially between the 10 year and 30 year bond. The reason that one would normally expect 30 year bond yields to show a larger gap against 10 year bond yields is that investors will want to be paid more for the risk of lending for 30 years. All sorts of things could happen during that time including a sharp increase in inflation which would reduce the real value of the bond upon redemption if it was a conventional rather than index linked bond.

The year on year rate of inflation, as measured by the US consumer price index, is 2.4%, although the core personal consumption expenditure index, which the Federal Reserve monitors closely, stands at 1.9%. So, there is a real return there but it is taking an awful lot on trust regarding inflation over 30 years. This is not quite a flat yield curve, i.e. all maturities having gross redemption yields approximately the same, but it is still flatter than one would expect. The shape of the yield curve suggests investor caution about economic prospects. In a traditional upward sloping yield curve the long term yield's higher level would reflect positive growth expectations and the inflation which may come with it, not to mention the economic and political uncertainties that come with investing in such a long dated issue. On the other hand, a downward sloping yield curve is traditionally thought to portend a recession as interest rates are cut to try to provide a monetary stimulus to the economy. The USA does not have a downward sloping yield curve but it is flattish. What does this tell us about how investors view the US economy? In the foreseeable future, it is possible to imagine a situation where the enormous tax cuts announced at the beginning of the year cause an already quite buoyant economy to overheat. Economies have automatic stabilisers in terms of the appropriate monetary and fiscal policy which can be activated

at the time. When an economy is growing rapidly, in order to avoid overheating, monetary policy can be tightened by raising interest rates to slow it down or, fiscally, taxes could be raised and/or public spending cut. When an economy is weak, the reverse policies can be implemented. A very large fiscal stimulus applied to the US economy adds fuel to the fire of expansion which could cause the economy to come up against capacity constraints, exacerbate inflation and cause the Federal Reserve to tighten monetary policy more quickly than otherwise would have been the case. Meanwhile, the US budget deficit would have ballooned and, over time, the increased servicing costs of the debt would weigh down on the federal budget. In order to deal with this, taxes would have to be raised or spending cut, or both, which would slow down the economy. Economists consider that there is a tipping point for the level of outstanding public debt as a percentage of GDP (some say in the 90% region) at which growth becomes affected by these factors. If investors believe that the long term potential growth rate of an economy is going to be permanently slowed, then interest rate expectations can be lowered, since the need to dampen down economic activity through monetary policy is reduced. But, even in this scenario, it is possible to say that, because the US Treasury has to issue so much debt to cover a high level of borrowing, interest rates should be higher to attract buyers. Of course, there are always natural buyers of long term fixed interest securities, but this does not satisfactorily explain the shape of the yield curve. Given the major fiscal stimulus to an economy which is already performing quite well and the resulting disabling of the economy's automatic stabilisers, one might have expected more concern to be expressed in the markets about inflation. But, if we look at the breakeven inflation rate implied between the yields on ten year inflation linked and conventional Treasury bonds, which is just under 2.2%, the market does not seem overly concerned about the inflationary implications of what is happening on the fiscal front. Another puzzle is that monetary policy is tightening in the USA. This is being effected through the gradual increase in interest rates and also the winding down of quantitative easing (quantitative tightening) as the Federal Reserve undertakes a phased reduction in the amount of maturing assets which it reinvests. Added to that, the increase in supply of US government debt arising from the expanded federal budget deficit, which one would expect might require a higher interest rate to make it attractive, and one has a combination of factors which might be expected to push interest rates higher.

The eurozone is still the subject of the ECB's quantitative easing programme, albeit at a reduced rate compared to last year at €30 billion a month rather than €60 billion. So, monetary tightening is being effected by a reduction in the rate of increase in the ECB's balance sheet but still remains ultra loose and might best be described as a reduction in the rate of increase in monetary loosening. The range of gross redemption yields for German government bonds at the time of writing is -0.595% for 2 years, 0.561% for 10 years and 1.241% for 30 years. The latest year on year consumer price index for Germany is 1.6% and the core rate 1.3%. In all of these maturities, both measures of inflation exceed the yields on the German government bonds which, in more normal monetary conditions, would be considered unusual. One reason why German government bond yields should be relatively low is that Germany is an excellent credit and a "go to" credit in times of economic difficulties. We can also explain the negative 2 year bond yield by the ECB's short term interest rate level at zero and negative bank deposit interest rates. Even so, investing for a certain short term loss, if the 2 year bond is held to maturity, implies some serious concerns and, as an investment manager, one would have to have a good explanation for doing so. As the ECB has to set interest rates for a currency union, it has to choose the level which most closely reflects the average need of eurozone members. Although the German economy has shown one or two signs of stuttering, for example the ZEW Indicator of Economic Sentiment for April fell by 13.3 points to -8.2 and industrial production in February fell by 1.6% compared with January, it is still in strong shape overall and these levels of interest rates would not generally be considered as appropriate. One can see inflationary pressures building up, for instance in the level of pay demands and the incidence of industrial action in support of these. Because the euro is undervalued, if one took Germany's circumstances alone, the currency cannot react to Germany's large current account surplus in isolation. If Germany still had its own currency it would be higher relative to other eurozone members if they, too, still had their own currencies and this would put downward pressure on inflation. Negative real interest rates for Germany, which is what we currently see, do not appear appropriate and pose a risk to inflation in that country. However, although it is

difficult to justify these yields on a fundamental level in Germany, one can see that, as and when quantitative easing ends in the eurozone and countries have to market the attractions of their debt as investors evaluate the interest rates they are prepared to pay for each country's credit, the high quality of German debt will appeal even if it means taking an unattractive absolute interest rate. With Germany having a very strong budgetary position, its need to issue debt is very limited. Ignoring the distortions at the 2 year end of the bond market caused by the ECB's short term interest rate setting policy and comparing highly indebted Italy (public debt at around 130% of GDP), with Germany, an interest rate differential of about 1.15% in the 10 year government bond market between the two countries' debt and about 1.6% in the 30 year market seems inadequate. If this is a correct assessment, we can say that the fact that the eurozone bond market is not giving out realistic signals is due to the suppression of yields as a result of the ECB's quantitative easing programme.

Turning to the UK, the spread of government bond yields at present is 2 year's maturity at 0.789%, 10 years at 1.426% and 30 years at 1.848%. The current rate of inflation, as measured by the consumer price index, is 2.5% so, again, some large negative real yields are apparent. Ten year breakeven levels as implied by the difference in yields between index linked and conventional gilts, stand at around 3% and around 3.3% at thirty years, which appears to be a realistic level, but the starting point is a strongly negative return on the index linked gilt. Although the yield curve is upward sloping, it is not a steep slope, so the difference between the 10 year yield and 30 year yield is relatively modest. Implied inflation rates at the 10 and 30 year levels would appear to make 30 year bonds extremely unattractive unless the economic outlook was so poor that such low yields appeared attractive in a deflationary environment. The UK is no longer engaged in quantitative easing but neither has it started to unwind it. The Bank of England is most likely set on a course of raising interest rates and, at some stage, will want to reverse quantitative easing. With government bond yields so low and monetary tightening occurring, one would expect upward pressure on yields. Set against this, to a modest extent, is the improving state of government finances. The UK has been seen in the past as an inflation prone economy and recent levels of inflation have been higher than elsewhere, but the level is now falling having hit a peak of 3.0% in January and now standing at 2.5%. The post Brexit vote weakness in sterling should now have made its way through the CPI unless very recent sterling weakness continues. Nevertheless, significantly negative real returns do not appear attractive and it is difficult to justify investing for such long maturities at significantly negative real yields.

In Japan, the yield on 10 year Japanese Government Bonds is artificially suppressed by the Bank of Japan's aggressive monetary policy which calls for 10 year JGB yields to be kept as close to zero as possible. At the time of writing, they are 0.035%. The 30 year JGB yield is 0.736% which, given Japan's history of deflation, may not be as unrealistic as elsewhere but, set against the official policy of targeting 2% inflation to reverse this long term trend, does not look so attractive.

So how do we make any sense of what the bond markets are telling us or is there any sense to be made of them? There is a school of thought which says that the world economy is going to face a long period of sub-average growth because countries are weighed down by the increased level of debt which they have taken on following the 2008 financial crisis. Quite a lot of countries have outstanding public debt to GDP levels of over 90% not to mention high levels of private debt. So one may expect their long term potential growth rate levels to be quite modest. That may keep inflation quite low but in no major country, with the possible exception of Japan, can one feel at all confident in saying that longer term bond yields are realistic measured against possible inflation levels. However, for them to be realistic at current levels, they would have to experience a period of poor economic performance and there is not enough evidence to support that argument in our view. We conclude, as we have done for some time, that the bond market remains extremely expensive and that, other than at the short end, where the price risks are much less, but where the yields are minuscule, it carries a significant price risk. Yields at the short end of the US Treasury market are much higher and are relatively attractive compared with comparable government bonds in the UK, eurozone and Japan.

Clearly, we will have a better picture when monetary policy returns to normal, although that may be a long way away. However, as it unwinds we may have some clues as distortions are reduced. It will be particularly interesting in the eurozone where yield suppression has distorted the yield differences which the various credit qualities should show in normal circumstances.

We have looked at the IMF's latest economic forecasts, we have tried to make sense of the various countries' yield curves and absolute bond yield levels and we have discussed how bad protectionism is for the world economy, so we will conclude by looking at some of the recent economic data.

In the USA, the important purchasing managers' indices stand at levels which indicate continuing satisfactory economic growth. The latest PMI for manufacturing stands at 59.3 and that for non-manufacturing at 58.8. Although the non farm payroll figures for March were lower than expected at 103,000, they came after a very strong reading for February at 326,000. One should be wary of sharp swings in the monthly figures and note that the longer term average is healthy. The unemployment rate remained unchanged at 4.1% for the sixth consecutive month. The Labor Force Participation Rate was fractionally lower at 62.9 against 63.0, although it had been at 62.7 in January. This figure should always be looked at in the context of the unemployment rate. After a weaker January and February, retail sales picked up in March to show a month on month increase of 0.6% and a year on year increase of 4.5%. Capacity utilisation levels have been creeping up and stand at just over 78%. This is an important figure because we discussed earlier the dangers of providing a significant fiscal stimulus to an economy which was already performing well. When an economy comes up against capacity constraints, inflation is liable to accelerate. This is for the future. Consumer sentiment, as measured by the University of Michigan index did, however, weaken in April to 97.8 from 101.4 in March. This was due to concerns about President Trump's trade policy, so how this develops may be an important indicator for the US economy. We discussed earlier the good first quarter earnings coming through from US companies, assisted by the corporate tax cuts. Especially if some of the savings for companies find their way to increased business investment which will help to raise the long term productive potential of the US economy, that will be important. Share buybacks as well as increased dividends, which also find their way back to the economy, will also be funded by the tax cuts. Mostly, therefore, the news from the US economy is good and should be supportive of the stock market. Dangers will arise if trade policy gets out of hand, resulting in a trade war and, further away, that the economy overheats as a result of the fiscal stimulus, inflation rises, interest rates have to be increased more quickly than currently indicated and the brakes are put on the economy as a result. On balance, the outlook appears positive for this year and next but we will have to watch events after that and, as we mentioned at the beginning of this review, the IMF expects some slowing down from 2020.

As far as the eurozone is concerned, the latest purchasing managers' indices have relieved some of the concerns which arise from some recent weak data suggesting at least a temporary pause in an otherwise satisfactory outlook for 2018 and 2019 as shown by the IMF's latest forecasts, outlined at the beginning of this review. The latest composite eurozone PMI for April showed no deterioration on March's level with both readings at 55.2, implying modest economic growth. In January, the index had stood at 58.8. Germany had been a concern because its composite index which had stood at 59.0 in January had fallen to 55.1 in March. The latest figure for April shows some slight recovery at 55.3. France, too, had shown some deterioration from a composite index reading of 59.6 in January to 56.3 in March before rising to 56.9 in April. With France experiencing considerable industrial unrest, particularly on the railways, it remains to be seen how this will affect the economy in the second quarter. Eurozone unemployment levels have been creeping gradually lower with the latest figure for February standing at 8.5% compared with 8.6% in January. At the time of writing, one economic headwind has eased, this being the strength of the euro which could make life difficult for the eurozone's exporters. In 2017, the euro's trade weighted index rose by 5.4% but, so far this year, the rise has moderated and the index is only fractionally above its year end level. Since its peak on 8th March, the euro's trade weighted index has fallen by about 1.3%. Politically, President Macron's push for eurozone reform seems to have stalled because of lack of interest from a coalition German government weakened by the poor election showing of both main parties in last year's federal election. The important issue is what

a new Italian government will look like and how the eurosceptic parties will address the country's problems without causing major trouble for the eurozone. On the economic front, investors will eagerly await the ECB's decision on its quantitative easing or quantitative tightening policy after September. Given the level of dividend yield on European equities (the Euro Stoxx 50 yields approximately 3.3%) and the forward P/E on that index of around 14, we remain of the view that European equities form an important part of an international portfolio. We are more influenced by the quality and prospects of many European companies rather than the potential problems of the eurozone of which there are many.

Turning to Japan, it remains to be seen what the effect of the political troubles surrounding Mr Abe have on economic policy and his reform plans, if any. Japan does not make any great headlines economically these days despite it being the world's third largest economy. Most interest economically now probably surrounds the course of Japanese monetary policy. The Bank of Japan has followed the most aggressive monetary policy of all and the size of its balance sheet is roughly equivalent to the size of the country's GDP. At its recent meeting the Bank of Japan maintained its stance but removed a time frame for reaching its target of 2% inflation. The latest consumer price index shows a year on year increase of 1.1% with the equivalent increase for the core inflation rate at 0.3%. The Bank of Japan has maintained its forecast for inflation for the next fiscal year at 1.8% and the same for the following fiscal year ending in March 2021. So the failure to mention a timescale for achieving its 2% inflation target suggests a more relaxed approach to attaining its target. As in a number of other countries, Japanese equities are in the unusual position of yielding far more than government bonds with the Bank of Japan monitoring its policy of trying to keep the 10 year bond yield at around 0%. The Bank of Japan has also been a large buyer of equity index exchange traded funds amounting to the equivalent of US\$183 billion. The equivalent of US\$17.4 billion was bought in the first quarter of this year. Although this is not the best combination of drivers to provide backing for Japanese equities, the performance of the Japanese economy gives confidence for the Japanese equity case. Investors can worry about the unwinding of this huge position at a later date.

The Chinese stock market has underperformed so far this year and fallen back sharply from its January high. The threat of a trade war with the USA has unsettled the market with China running a large trade surplus with the USA, last year amounting to US\$375.2 billion so, on the surface, it has far more to lose from a trade war. Of course, it is not as simple as that. The collateral damage from a trade war would be substantial. Investors in China, with its enormous economic potential, have to hope that the President, with his significant accumulation of power, uses it wisely. With the party increasingly becoming embedded in companies, corporate governance has to be a concern for outside investors. As we mentioned earlier, there are some liberalising measure taking place and the Chinese authorities have recently announced that a Shanghai-London stock exchange trading link will open by the end of the year. There is also an increase in the daily quota of mainland Chinese shares, "A" shares which can be purchased through the Hong Kong Stock Connect to the equivalent of about US\$8.3 billion, four times the present limit, and, likewise, a quadrupling of Hong Kong listed shares which investors can buy through mainland Chinese stock exchanges.

Although the first quarter of 2018 UK growth estimate was disappointing at 0.1%, and it must have taken a hit from the bad weather in March, our main concern remains the political risk in the UK. Looking at the views of international investors, the UK comes towards the bottom end of their list of favoured markets due, it seems, to the possibility of a change of government rather than Brexit. This has been our view as the opposition has espoused policies which, by UK standards, would be seen as extreme. The risks to the stock market and sterling would be clear. For that reason, where our mandate allows, our clients' portfolios have been heavily slanted to overseas markets. That has always been the case, but we feel that this policy is more essential than ever. Whilst the Fixed Term Parliament Act has made the calling of a General Election more difficult, it would be possible if the governing coalition split and a vote of no confidence was carried and no alternative government is confirmed by the House of Commons within fourteen days. The UK appears to be facing a crunch moment in the Brexit negotiations as remainers in the House of Lords and within the Conservative Party try to tie the government's hands to stay in the customs union. Were the government to give way on this, it is

likely that the Conservatives would split. We think investors need to factor this possibility into their thinking. The government is particularly vulnerable on a no confidence motion if the Democratic Unionists changed sides over the Irish border issue. So, in the UK, politics, rather than economics, is the main investment issue for us and the insurance policy, apart from being sensible on diversification goals, is for a portfolio to hold a substantial percentage of its assets in overseas securities.

As we have warned in many of these reviews, after such a long run of positive returns, it is inevitable that there will be some quarterly setbacks and the last quarter was one such of these. The challenge for investors in equity markets remains to balance the prospect of rising interest rates with continued satisfactory economic growth and advances in corporate earnings. This makes central banks' signalling very important and they are sure to be careful that they get this right. With interest rates likely to be on a rising trend, it is important to relate this to better economic conditions and move to normality in monetary conditions, albeit that this will take a long time. We have discussed at some length the bond market in this review and we remain negative on it. For sterling based investors, it remains important to maintain significant geographical diversification in view of our opinion that the UK is a high risk market.

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