meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Because of the current circumstances, we are producing an abbreviated version of our regular economic review. We hope you will understand why it is necessary to do this with all members of staff working from home and the office unavailable for use until the emergency is over.

Selected International Equities Indices 31.01.20 - 30.04.20

Total Return Performances (£ terms)	**%**
UK	-18.4
USA	-5.2
All World Europe ex UK	-12.7
Japan	-6.5
Australia	-19.1
All World Asia Pacific ex Japan	-5.9
All World All Emerging Markets	-9.3
All World	-8.0

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +6.3%

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

Currency	31.01.20	30.04.20
Sterling	0.52	0.23
US Dollar	1.51	0.61
Yen	-0.07	-0.04
Germany (Euro)	-0.44	-0.59

Sterling's performance during the quarter ending 30.04.20 (%)

Currency	Quarter Ending 30.04.20
US Dollar	-4.8
Canadian Dollar	+0.5
Yen	-5.9
Euro	-3.4
Swiss Franc	-4.5
Australian Dollar	-1.8

Other currency movements during the quarter ending 30.04.20 (%)

Currency	Quarter Ending 30.04.20
US Dollar / Canadian Dollar	+5.3
US Dollar / Yen	-1.4
US Dollar / Euro	+1.3
Swiss Franc / Euro	+1.1
Euro / Yen	-2.7

Significant Commodities (US dollar terms) 31.01.20 30.04.20 (%)

Currency	Quarter Ending 30.04.20
Oil	-54.3
Gold	+7.9

ECONOMICS

We reflected in March's review on the implications and consequences of the coronavirus pandemic as well as detailing the response of the larger countries or regions in terms of monetary and fiscal policy. The aim of detailing these measures, and there have been more announced in April, was to give some idea of the mind blowing magnitude of the measures taken to preserve the infrastructure of economies in terms of businesses, individuals and the productive capacity of economies when this is all over. In taking these actions, it is right to say that lessons have been learned from mistakes made in previous crises, starting with the Great Depression right through to the Global Financial Crisis (GFC) in 2008/9. Exceptional circumstances require exceptional responses and this is what has happened. So, in relation to what we wrote about last month in relation to monetary and fiscal policy, the mind blowing figures have become even larger. The point to make is that governments and central banks are prepared to do whatever it takes to support their own countries and, by extension, the world economy. One can argue about the likely effectiveness of the measures and the long term consequences of their actions, but no one should doubt that all the stops are being pulled out. So, in this review, rather than go over again the detailed measures taken so far, we will try to speculate on the economic and financial consequences, including, of course, those for investors.

From a public health aspect it is of paramount importance that the risk of a second wave of the coronavirus is minimised, either through the successful containment of the first wave, horrific as it is now, or through the successful discovery of a vaccine. Even though scientists are working hard on this throughout the world, time may be against them for this year. Of prime importance is public health, but it cannot be eventually divorced from the state of the world economy, hence difficult decisions which have to be made in terms of the trade off between public health and the danger to the world economy of prolonging the lockdowns, at least in their most severe form. If a second wave of the coronavirus arrives after the lockdown is lifted or relaxed and it has to be reinstituted, the economic consequences are likely to be even more devastating. The trade off between these two issues is the hardest that governments around the world have to make. This is becoming a more difficult issue for governments as each day passes. Pressure from businesses and individuals to relax the lockdown is growing. However, if the lockdown is relaxed too early and a second wave of the coronavirus occurs, governments will surely get the blame. It is an invidious choice for them.

Whatever the outcome, unemployment levels will rise strongly. Some businesses will fail and not resume operations, others will see their business model upended and, even if they stay in business, may need fewer staff. On the other hand, some businesses will see their business prospects enhanced. The relationship between business and government will change in many cases and this has implications for shareholders. With so much taxpayers' money directly and indirectly supporting business, the governments of the world will put restrictions on companies' right to do certain things whilst they still owe money to their various governments. The most obvious areas are share buybacks, dividends, executive pay and bonuses. Even if they do not require direct support, they may be subject to regulatory pressure or diktats. European banks are a case in point, with dividends having been cancelled after they had already been declared in some cases. In businesses deemed strategic, say, airlines or aerospace, governments may take an equity stake thereby diluting existing shareholders. Businesses which have faced a near death experience, like the railways in the UK, are effectively in government hands. One of many extraordinary events has been the collapse in the oil price with storage tanks being almost completely full and the price turning briefly negative. This has led, amongst other things, to another "black swan" event, Royal Dutch Shell cutting its divided by two thirds, the first time since the war. This is traumatic for many investors because this is one of the shares on which they rely for income. For consumers, even though most of the price of petrol is accounted for by tax, the fall in price acts as a tax cut and, for industry, as a useful reduction in their costs, but it also has negative side effects. One is that, for many producers, the costs of production are well over the current oil price. Shale oil producers in the USA, for example, which are often marginal producers, are at risk and so are the banks which have lent them money and the investors who have bought their bonds. Then there are countries like Saudi Arabia whose costs of production are very low but whose budget is predicated on an oil price far in excess of the current one. The country is having to draw on reserves and raise taxes amongst other measures. As one example, VAT is to be tripled from 5% to 15% on 1st July. The credit ratings of some oil producing countries are under threat. For bond investors, credits which were acceptable in more normal times, have now become concerns in many cases.

Although it may not seem like it, the relatively brief period of the lockdown already gives us some clues as to the way things may change in the future. Many employees have been on a sharp learning curve as far as remote working is concerned but it is already clear that some employers and employees will have changed their attitude to working from home. For the employer, an obvious benefit is that they may not need so much office space. For the employee, avoiding a long and expensive commute has attractions, physically, materially and financially. So this may be bad for owners of office buildings but good news for parts of the IT sector. That is already evident in the relatively good share price performances of some technology stocks. The attraction of online shopping, whether by necessity or choice, has clearly increased and companies in this field are likely to see a long term benefit, whilst bricks and mortar retail outlets, many already under severe pressure, will find their predicaments worsen and already a number of retailers have failed. The retail property sector will find life even more difficult as rental income falls. Video conferencing and calls have taken off as travel has been curtailed. Many companies and people will now query whether they actually have to travel to a meeting or conference, especially when they have taken a big financial hit from the lockdown. They will be looking to cut costs. Curtailed business travel will affect airlines, hotels and the hospitality industry in general. Although, sadly, unemployment will rise, the need to do business more smartly to save costs could mean an increase in productivity, the low level of growth of which has been a concern for the UK and other countries.

One of the worries of the UK government and, almost certainly others, is how people will react once the lockdown is lifted. There has been a high level of observation of the lockdown rules in the UK and elsewhere, but the economic worry is that it will have affected people's attitude to the way of life they had before. For instance, the disciplines of social distancing might endure after the need has passed. So this could affect restaurants, hotels, theatres and events which attract large gatherings. The economic hit for many people will be such that their spending will be reined back. If the change of attitude endures, economic recovery may be slower.

On the other hand, the exhortations from governments and health authorities regarding hygiene and how attention to it is one way of reducing the risks of catching the coronavirus will benefit companies in the healthcare and hygiene industry and it is quite likely that the acceleration in sales which they have seen may continue in the future. A sector which may have seemed tired like branded foods has made a recovery as people have been forced to eat at home rather than go out for meals. If people are more nervous about eating out, then this is a trend which may endure for some time.

Turning now to broader issues, it is important to note that this economic crisis is one caused by a collapse of supply which, in turn, has led to a collapse in demand. With many people unable to work because of the lockdown, the supply of some goods and services has been interrupted. In this context, globalisation has received a lot of attention. The theory of comparative advantage posits that goods and services are provided most effectively where countries have a comparative advantage and, where they do not, they import those goods and services. This is a very simplistic description of the theory but it informs the way world trade has developed. The supply chain has become truly international. A car or aeroplane will have parts manufactured in many countries with parts being sent to the country where the final assembly takes place. It is also likely to have been done on a "just in time" basis so that parts arrive at the final assembly plant just before they are needed. This has the advantage of holding down working capital requirements because it is not necessary to hold large stocks of parts. Thus, broadly speaking, the theory has now been put into practice through the development of globalisation. The theory has, however, now received its most serious challenge to date. Many parts used by western manufacturers are produced in China and when Wuhan, an important manufacturing hub, went into lockdown so supplies of parts to manufacturers in other countries were curtailed and this situation worsened as the lockdown spread. Final assembly plants were therefore disrupted. This is one reason why companies may feel that they have to de-risk their business by either manufacturing more parts in house or in their own country or region. There is also the political angle. Tensions have clearly increased between the USA and China, but also between Europe and China, and it is difficult to know how this will play out in terms of trade. There was already substantial tension before the outbreak of the coronavirus, as evidenced by the USA/China trade war, and the feeling that protectionism is becoming more embedded as a result of the fallout from the pandemic is growing. Economic nationalism will certainly increase. This may lead to more inefficiencies which some companies or their respective governments may see as an acceptable trade off if security of supply is enhanced.

This is related to another important issue which might be relevant to certain elements of the stock market and that is the increase in the influence of governments in business as they take over sectors, for example railways in the UK, and provide vast financial support to other companies directly and indirectly. Governments are using extraordinary powers and influence as they have to in a crisis like this. The question is how long lasting will this increasing influence be? In many ways, governments have had to nationalise large parts of their economies, an issue which investors will have to consider in terms of shifts in the balance of power between governments and investors. How this will turn out may depend on the political complexion of relevant governments.

One issue on which there can be no doubt is that the measures taken by governments to stabilise their economies have led to extraordinary levels of government borrowing and outstanding public debt. The figures quoted in our March review are already out of date but they point to astronomic sums being borrowed, so the question is what are the implications of this? At the moment, this additional debt is being financed at the ultra low levels of interest rates indicated at the beginning of this review. Whilst absolute levels of interest rates are low or negative, one can see signs of strain in some markets. So, for example, in the eurozone, the market that some investors are particularly concerned about, we see the spread between the yields on Italian and German government ten year bonds widening to nearly 240 basis points at the time of writing. The big buyers are the central banks whose balance sheets are ballooning. They can create money electronically to purchase bonds (now expanded from just government bonds to corporates). This is a way of controlling interest rates and providing liquidity to the banking system. Theoretically, this can be reversed at some stage because, when the central banks want to reduce the size of their balance sheets and follow a more restrictive policy, they can sell down their holdings of bonds. In the current crisis, former restraints on what can be purchased have gone by the wayside in terms of, for example, credit quality and types of asset. In Japan, for example, and they have been doing this for some time, the central bank is buying equities through exchange traded funds. There is a fine distinction between this type of quantitative easing and direct central bank financing of governments' expenditure. Many people regard it as the same thing. In the past, economists would have regarded with horror the idea of central banks printing money for the government to use and they still do for some countries. The theory and practice mean that inflation takes off as there is no confidence in the local currency. Venezuela and Zimbabwe are cases in point. For countries with much better credit ratings and which can print their own currency, some economists who espouse Modern Monetary Theory believe that this can be done. At present, investors can be reasonably confident that, if they buy bonds in the primary market and the country in question, through its central bank, is buying bonds in the secondary market, their risk is limited. More traditional economists fear that an explosion in the money supply at a time when the supply of goods and services is limited will eventually lead to higher inflation when confidence returns and the money circulates more quickly.

The financing of government debt, whilst a major issue for every country, is a particular one for the eurozone where individual central banks do not have the ability to issue their own currency, so their freedom of manoeuvre is very limited. It is bringing together countries with very different attitudes, and tensions have noticeably increased between the different eurozone members. Countries such as Germany and the Netherlands have a very different attitude to those in southern Europe with which France increasingly sides. EU rules specifically forbid the direct financing of government deficits. The Stability and Growth Pact deficit rules have already gone out of the window as have the rules on purchasing government bonds according to the capital key rules (countries share of capital in the ECB). The push is now on for debt mutualisation bonds, something which Germany and the Netherlands vigorously oppose on the grounds that their taxpayers will be picking up the bill for other countries, particularly Italy, which is heavily and worryingly over indebted.

Now the difficulties for the ECB have been increased by the German Constitutional Court's ruling on the ECB's asset purchase programme. The ECB has been given three months to show why this is in line with the law and this ruling has set up a major clash between the European Court of Justice and the German Constitutional Court with the latter challenging the ECB's monetary authority and talk of the EU taking Germany to court. The pandemic has exposed still further the strains within the eurozone. The eurozone is not an optimal currency area and the lack of a fiscal union exposes its limitations and flaws. As is probably inevitable, members of the EU have mainly been considering their own national interests rather than that of the EU as a whole during the pandemic. The EU perhaps faces an even bigger challenge than other countries because of the inherent contradictions in a currency union which is not optimal.

So what conclusions can we draw for investors? The balance sheets of countries and their central banks will look completely different once this crisis has abated. Government debt as well as private debt will have exploded in size. At the moment, vast amounts of this debt is being hoovered up by central banks as they seek to provide liquidity and manage interest rates. But this cannot go on indefinitely and it is hard to see this development as being good for fixed interest investments. The price of debt in the form of interest rates is almost certain to rise as the borrowing demands of governments expand enormously. Whilst, in a crisis position, investors might feel safer in good quality bonds at very low or negative interest rates, this is hardly a sustainable investment policy, given that in all but the most extreme circumstances fixed interest investments are fundamentally significantly overpriced. Whilst there may not be a full reversion to mean in interest rates in the foreseeable future, any significant movement towards that will involve meaningful negative returns. Whilst, in the short term, cash might make investors feel more comfortable, it is showing, in many countries, a negative real return. Again, investors may not be concerned about that in the short term but, over the medium and long term, it is not a sustainable investment policy and cannot meet the reasonable investment objectives of investors. We will exclude gold from this discussion as it has never formed a significant part of our investment portfolios, although, in recent times, as our table at the beginning of this review shows, it has performed well recently in line with its traditional investment appeal as a store of value in uncertain times. We would never hold an extreme position in gold and, of course, it provides no income if held in physical form or through exchange traded funds. This leaves equities which remain our preferred asset. Many commentators are surprised about the extent of the rebound in share prices since the 23rd March low point and, of course, we cannot be certain that share prices will not retest these levels. However, selling good quality shares, even when the background looks dreadful economically, as it does now, can prove expensive in terms of opportunity cost, the best example being those intimidated out of the market by the GFC in 2008/9 who then missed out on the long bull market in equities. In our March review, we pointed out the importance of investors looking at the likely effect of the huge economic stimuli provided by governments throughout the world. Eventually these will feed through to economic activity and, as in the GFC, cheap money raised asset prices. Simply put, it is lot more money chasing a limited supply of equity assets. Markets look ahead and, dreadful though the news is now, it will become less bad in terms of the virus at some stage, we can reasonably hope, and also for economic activity. There is a difference of view between the ultra pessimists who believe the economy is likely to experience an

“L” shape performance, i.e. a dramatic decline in economic activity and then a levelling off at the lower level, those who say it will be a “U” shape recovery, i.e. it will only be a gradual recovery, and the optimists who think it will be a “V” shaped recovery, i.e. it will bounce back sharply. We think the “L” shaped view is the least likely of the three views. In this situation, given our belief that bonds can offer no long term value, equities become, at the least convincing level, the asset of choice by default. We have made the argument for equities previously that their strong performance last year and at the beginning of this year could be partly accounted for by their yield advantage over high quality bonds. Now, of course, dividends in some countries have taken a hit, mainly it seems in the UK and Europe at present, and this makes the argument less strong but, we believe, still valid. Also, we need to recognise that, with governments taking control over large parts of the economy as a result of their financial support, shareholders may be in a less advantageous position. We can cite here the examples of UK and EU banks being forced to omit or cancel already announced dividends or indirect pressure being placed on insurance companies to do the same. Whilst we have to recognise these factors, we do not think it invalidates the argument for a well diversified portfolio of international equities. Within the international equity markets, there have been wide divergences of performances between growth and value stocks, with the latter, because of the sectors they represent at this time, underperforming sectors like technology, healthcare and some consumer staples companies. If investors become more confident, then these left behind sectors can be expected to show some relative strength as their business prospects improve, although it would be premature to believe that at the moment.

Whilst equity market performances in April show that some of March’s decline has been clawed back, and this is encouraging, no investor should be lulled into a sense of complacency. The economic losses are horrific and the road to recovery uncertain, but medium and longer term investors should consider the factors which, to us, give equities the edge over other asset classes. As we have said before, when markets have hit turbulence, it is important not to be intimidated by the news, and here we must emphasise that the media mostly emphasises the bad news, because, if one is intimidated in this way, hasty decisions to sell good quality equities can prove very costly in the long term. Pleasingly, for the moment, volatility has fallen sharply and, probably, most weak holders or those who have had to sell shares, perhaps because of margin calls or over leveraging, have left the market. We must still expect a bumpy ride and markets will fluctuate according to the latest news, but it is important to concentrate on the longer term outlook which, in our view, favours equities.