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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

International equity markets have nudged higher during the quarter with a noticeable outperformance from last year's laggards, Latin America and emerging markets. This movement has been against an unpromising geopolitical background and the re-emergence of the eurozone's economic problems. There has been a remarkable fall in high quality bond yields. Currency movements have been relatively modest.

The tables below detail relevant movements in markets :

International Equities 30.05.14 - 29.08.14

| Total Return Performances (%) | | | | |
|-------------------------------|----------------|-------|-------|-------|
| Country | Local Currency | £ | US\$ | € |
| Australia | +3.3 | +4.9 | +3.8 | +7.6 |
| Finland | +2.3 | -0.2 | -1.2 | +2.3 |
| France | -3.0 | -5.5 | -6.4 | -3.0 |
| Germany | -4.7 | -7.0 | -8.0 | -4.7 |
| Hong Kong, China | +4.6 | +5.7 | +4.7 | +8.4 |
| Italy | -3.8 | -6.2 | -7.2 | -3.8 |
| Japan | +6.0 | +4.9 | +3.8 | +7.6 |
| Netherlands | +0.8 | -1.7 | -2.7 | +0.8 |
| Spain | +0.8 | -1.7 | -2.7 | +0.8 |
| Switzerland | N/C | -1.4 | -2.4 | +1.1 |
| UK | +0.7 | +0.7 | -0.3 | +3.3 |
| USA | +4.7 | +5.8 | +4.7 | +8.5 |
| Europe ex UK | -1.6 | -3.9 | -4.9 | -1.5 |
| Asia Pacific ex Japan | +4.1 | +5.8 | +4.7 | +8.5 |
| Asia Pacific | +5.0 | +5.3 | +4.3 | +8.0 |
| Latin America | +15.0 | +15.2 | +14.1 | +18.2 |
| All World All Emerging | +9.1 | +9.7 | +8.6 | +12.5 |
| The World | +3.7 | +3.9 | +2.9 | +6.5 |

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +3.8%

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

| Currency | 30.05.14 | 29.08.14 |
|----------------|----------|----------|
| Sterling | 2.57 | 2.37 |
| US Dollar | 2.47 | 2.34 |
| Yen | 0.58 | 0.50 |
| Germany (Euro) | 1.36 | 0.89 |

Sterling's performance during the quarter ending 29.08.14 (%)

| Currency | Quarter Ending 29.08.14 |
|-------------------|-------------------------|
| US Dollar | -1.1 |
| Canadian Dollar | -1.0 |
| Yen | +1.1 |
| Euro | +2.6 |
| Swiss Franc | +1.5 |
| Australian dollar | -1.5 |

Other currency movements during the quarter ending 29.08.14 (%)

| Currency | Quarter Ending 29.08.14 |
|---------------------------|-------------------------|
| US Dollar/Canadian Dollar | +0.1 |
| US Dollar/Yen | +2.2 |
| US Dollar/Euro | +3.8 |
| Swiss Franc/Euro | +1.1 |
| Euro/Yen | -1.5 |

Significant Commodities (US dollar terms) 30.05.14 - 29.08.14 (%)

| Currency | Quarter Ending 29.08.14 |
|----------|-------------------------|
| Oil | -5.7 |
| Gold | +2.7 |

MARKETS

International equity markets have edged higher during the quarter and bond yields, as measured by those on high quality ten year government bonds, have fallen sharply. The FTSE World Index (total return) has risen 3.7% in local currency terms, in sterling terms it has returned 3.9%, in US dollar terms 2.9% and in euro terms 6.5%. Looking at local currency returns first, we note that the strongest performers have been in the FTSE Latin American Index (15.0%) and in the FTSE All World All Emerging Markets Index (9.1%). Japan also performed well with the FTSE Japanese Index returning 6.0%. On the other hand, Europe ex UK was the weakest area with the FTSE Europe ex UK Index returning -1.6%. If we look at sterling based returns, the FTSE Latin American Index and FTSE All World All Emerging Markets Index showed even higher returns than in local currency terms at 15.2% and 9.7% respectively. Also in sterling terms, the FTSE USA Index performed well returning 5.8%, as did the FTSE Asia Pacific ex Japan Index which returned 5.8% and the FTSE Australia Index which returned 4.9%. Because of weakness, particularly in the euro, the negative return on the FTSE Europe ex UK Index increased to -3.9%.

In the bond markets, there were some significant falls in gross redemption yields on high quality ten year government bonds. The UK government bond yield fell by 20 basis points to 2.37%, the US Treasury bond by 14 basis points to 2.34%, the Japanese government bond by 8 basis points to 0.50% and, most extraordinarily of all, the German government bond by 47 basis points to 0.89%. We will be discussing this phenomenon later on in this review.

In the currency markets, there were not large movements by some recent standards. The euro was the weakest currency and, against it, sterling rose by 2.6%. Against the Swiss Franc, sterling rose by 1.5%. On the other hand, sterling weakened slightly against the Australian dollar by 1.5%, against the US dollar by 1.1% and against the Canadian dollar by 1.0%.

In the commodity markets, notwithstanding the situation in the Middle East, oil, as measured by Brent crude, fell by 5.7% whilst gold rose by 2.7%.

ECONOMICS

Against a very serious geopolitical background in the Middle East and Ukraine and further bad economic news from the eurozone, it is testament to international securities markets' underlying strength that they have been able to withstand this news with (so far) little damage to markets. After a blip in markets in early August and a modest spike in volatility, markets, at the time of writing, have recovered their poise and volatility has fallen back. The S&P 500 index broke through the 2000 level without flinching. What are investors to make of this?

Alongside the terrible humanitarian crisis in the Middle East, there are potentially serious economic consequences if oil supplies are disrupted. In the Ukraine, it is difficult to know how the crisis will end. No one is going to gain from the tit for tat on sanctions, yet it would be optimistic to count on a rational solution. We are already beginning to see the effects in the eurozone, perhaps especially in Germany which stands to be a big loser should the stand off continue for any length of time.

So why have stock markets remained, at least so far, surprisingly unmoved by these terrible events in the Middle East and the Ukraine and brushed off some awful economic data from the eurozone? We think that it all comes back to monetary policy. Investors cannot be sure of many things but one of those which they almost certainly can is that interest rates, at least at the short end of the market, are likely to remain very low for the foreseeable future. There may be small rises in the USA and UK but they will still remain at very low levels. The search for yield is likely to continue, notwithstanding that it can be a risky business particularly in the low grade bond market where yields were driven down to dangerously low levels taking into account default risks. In most major markets, the USA excluded, and, of course, that is a big exclusion given its size, equity yields exceed those on the relevant ten year government bond. So even if equity yields in these markets do not seem particularly attractive in absolute terms, in relative terms against ten year government bonds, a regular benchmark, they do. Extreme monetary policy and the non standard element of it, quantitative easing, where practised (the USA, UK and Japan) has driven down bond yields to levels we would scarcely have believed credible a few years ago. The distortions caused by monetary policy in the bond markets look quite scary with many commentators warning of the dangers of the rush for the exit in the bond markets. This could cause problems for investors in open ended bond funds. Liquidity is not what it was in the markets and there are legitimate concerns about a potential rush of bond redemption requests.

Continuing with bonds, the most striking feature of the table at the beginning of this review showing the movements in ten year government bond yields over the last quarter is the collapse of the ten year German Bund yield to well below 1%. The ECB has not carried out formal quantitative easing although it is no longer sterilising its market interventions so it has a similar effect. The fall in eurozone bond yields must signify other issues, not only the very loose monetary policy which has led to such low interest rates. One issue is that eurozone inflation is very low, the latest figure being 0.3%, so even a 0.89% ten year German government bond yield provides a positive real return. It should be noted, however, that the core inflation rate rose slightly to 0.9%. Amongst the eurozone's many problems is the possibility that deflation may strike. Some eurozone countries are already experiencing deflation and an overall current inflation rate of 0.3% does not leave much room for error. Whilst many of us would prefer deflation to inflation, the economic effects of deflation can be quite serious, especially in the condition in which the eurozone now finds itself. The debt dynamics become even more serious in a deflationary environment. Whilst nominal outstanding debt will probably at best remain stable and more likely increase as the relevant countries would be mostly running budget deficits, GDP could be shrinking in nominal terms, the so called denominator effect, which increases the debt level as a percentage of GDP. Servicing costs also become more onerous. There is role reversal between debtors and creditors so that those who borrow money and are used to experiencing a falling real value of their liabilities because of inflation now find the roles reversed and experience an increase in their liabilities in real terms. This raises the possibility of more defaults which would affect the banking system. In these circumstances, investors would rationally seek to become more risk averse so ten year German government bonds yielding under 1% might seem a safe refuge. So extremely low yields, such as we now see in government bond markets like those of Germany, could reflect outright fear about the economic outlook. However, if this is what it is, it is surprising that equity markets have held up because such a background would be extremely troublesome for many companies as rational consumers, whether they be individuals or businesses, held off unnecessary purchases in the hope of buying more cheaply later on, creating a serious downward spiral for the economy.

If we put to one side the terrible geopolitical events which are occurring in the world and focus on economic issues, it is the problems of the eurozone which are the most troubling. Even though the

EU is in relative decline, it still accounts for approximately 19% of world GDP so what happens to the eurozone, which comprises most of the EU by GDP, remains important to the world economy. Following Mr Draghi's statement in 2012 that, to paraphrase, the ECB will do what it takes to save the euro, there has, in our view, been a quite unwarranted feeling, encouraged by those associated with the euro project, that the worst has passed. We have never believed this for one moment and the issues which are resurfacing in the eurozone at the moment are symptomatic of the fundamental problems of eurozone members like Spain, Portugal, Ireland, Greece and Cyprus. There are also serious problems facing France and Italy and, if not addressed, do pose a problem to the continued existence of the euro because of the size of those two economies, the second and third largest in the eurozone. As we have indicated in our reviews many times over the years we believe that, because the eurozone is not an optimal currency area, it will break up at some stage. What is striking is the length to which eurozone politicians and bureaucrats are prepared to go in defence of the concept of monetary union in spite of the extraordinary problems, including horrendous levels of unemployment, which it is causing. We believe that there will come a time when a new generation of politicians, not associated with the euro project, will question why their country remains in the eurozone.

By linking together into one currency countries with quite different economic characteristics and hoping that they would converge economically was completely unrealistic. Instead of converging, they have been diverging. If we just look at the three largest eurozone economies, Germany, France and Italy, we see that France and Italy have lost a considerable amount of competitiveness against Germany. Under a floating rate exchange regime, the loss of competitiveness would have been reflected in a weaker exchange rate which, whilst providing relief in the short term, would have needed addressing in the medium and long term in terms of devaluation's adverse consequences, notably higher inflation. The relevant governments, with external pressure from the foreign exchange markets and creditors, would have the choice of making difficult decisions provided their problems were not so bad that they had to take a loan from the IMF which would impose tough terms. On the other hand, the highly competitive countries would see their exchange rate appreciate and, unless they improved their competitiveness, could suffer a loss of business to cheaper competitors. With imports becoming cheaper, they could see a deterioration in their trade account after an initial improvement whilst the countries which had seen their currencies weaken, after the initial "J" curve effect, could see an improvement in their trade account, exactly the opposite effect. The "J" curve is the phenomenon whereby in the case of a country which devalues, it sees a deterioration in its trade account initially as imports become more expensive and exports cheaper. After a while, the trade account improves as exports increase and import substitution takes place as a result of increased competitiveness. This is a very simplified exposition of the effect. For instance, the pricing policy of the exporters may be to raise their domestic currency prices so that a similar level of foreign currency is received. They may decide to take the devaluation benefit in better margins rather than chase higher volume. But the point of discussing the potential benefits of a floating currency is to bring into contrast the problems facing a number of eurozone countries tied into a fixed currency regime. A floating currency is a shock absorber.

In this context, the current political crisis in France is a telling example of the problems the euro is causing. Most independent observers will agree on the problems facing France and why it is experiencing such difficulties. Amongst them are a very large public sector accounting for around 57% of GDP, very high individual corporate and personal tax rates, extremely rigid employment law rules which discourages businesses from taking on staff and, in some quarters, a mistrust of business and success which has led to an outflow of much entrepreneurial talent. Whilst it would normally be considered a French decision as to how or whether to deal with these issues, the resignation of the government and the cause of it is partly due to France being a member of the

eurozone. The austerity package imposed on France and other eurozone members aimed at improving the country's finances has resulted in the economy stalling with a very high unemployment rate of 10.2%. For other countries, internal devaluation, the alternative to external devaluation which is denied to eurozone members, means cutting costs including wages. None of this is going to help the demand deficiencies in these countries. This is what Mr Montebourg railed about. What France requires is radical structural reform aimed at boosting the supply side of the economy and increasing the country's long term potential growth rate. To do that requires a sea change in thinking and this is not likely to happen. Public finances and debt trends have to be brought under control. It is not enough to think that control of public finances can be jettisoned in the quest for growth and lower unemployment levels. Credit ratings would be cut and borrowing become more expensive in those circumstances. The imposition of austerity measures on affected eurozone economies within a fixed exchange system risks creating a vicious downwards cycle from which escape will be very difficult. Italy's problems are similar to France's. Whilst its budget deficit is lower than that of France, its overall public debt to GDP ratio is much worse, around 135% now, and its economy is similarly structurally rigid, thus denying employment opportunities, particularly to young people. Without wishing to be unduly pessimistic, it is difficult to see how the eurozone can escape its problems without abandoning monetary union. But, of course, that is not on the agenda of current eurozone politicians and bureaucrats which means that the eventual resolution of the problem will be even more messy.

In the short term, hopes are pinned on the ECB. In June, it announced a batch of measures to try to stimulate the economy and encourage the banks to lend more but the very poor economic numbers emanating from the eurozone have now led to calls for more action. As we said earlier, the ECB has not undertaken any formal quantitative easing and it may be a difficult action to take within the rules but there are reasons for doubting whether it would be successful in the eurozone, even if it were allowed. For a start, bond yields are very low. If the ECB were to buy eurozone government bonds in proportion to each country's GDP weight in the eurozone, it would be buying an awful lot of German government bond paper. Insofar as corporate bond yields sold off government bond yields, it is hard to believe that such a move would encourage companies to borrow more. With the additional cash which banks receive from quantitative easing, it would be hoped that this would encourage banks to lend more money but, with eurozone demand so depressed, it is difficult to believe that many companies would be enthused about borrowing more. Monetary policy loses its force at very low levels of interest rates and if a country moves into deflation can lose its force altogether.

In our opinion, the eurozone's issues are a major concern and now the euro has claimed a big scalp by forcing the President of France to ask the Prime Minister for the resignation of his cabinet due to outright rebellion from within the Cabinet against the austerity policies forced upon France. The new cabinet excludes the government's left wing economic critics. The immediate reaction of the French stock market was to rise. Why could that have happened? One reason might be the expectation that the new cabinet would have a better grasp of reality. The perception of France has been hugely damaged by the attacks on business by some politicians, particularly on foreign firms. When economic growth is desperately required, the logic is hard to fathom. A second reason could be that the supply side reforms, which the President announced at the beginning of the year, modest as they were compared with what is needed, would be pushed through with more vigour. A third one could be that if austerity, as required by the EU, was loosened then, as in the UK, the economy's automatic stabilisers could work. At the moment, austerity measures are pro cyclical, i.e. they reinforce the austerity whereas automatic stabilisers, such as additional government spending related to a recession, for example, in the area of social security and lower tax receipts because of

depressed spending and employment, help to offset weak economic influences. The risk of this policy is that, if markets felt that the government lacked discipline, it could pay for it with higher bond yields. One of the dangers, not only in the eurozone bond market but elsewhere, is that when interest rates return to normal there will be a gradual increase in debt servicing costs which could cause budget difficulties in many countries. We will look in more detail at some of the data from eurozone countries shortly. As always, however, we say that investors should look at the attractions of eurozone based companies in their own right and as not necessarily being tarnished by the problems of the country in which they are domiciled.

So, turning to more specific detail, we will firstly look at the USA. Here, things have gone quiet on the political front. The mid term elections are due in November and there is the possibility that the Republicans may gain control of the Senate in which case the stalemate between the executive and legislature will be complete. From a market point of view that is not necessarily a bad point. The US economy is moving forward at a reasonable rate and, after the traumas caused by the stand offs last year over the budget and debt ceiling, investors are likely to value a period of calm when few political initiatives can be made because of the deadlock between Congress and the President. As everyone knows, first quarter US GDP was badly affected by the weather in January and February and it showed a quarter on quarter annualised decline of 2.1%. In the second quarter, this bounced back to 4.2% growth. Year on year GDP has risen by 2.5%. The Purchasing Managers Indices, a high value indicator of the state of an economy, show quite strong numbers. The latest reading for the manufacturing PMI was 57.1 against 55.3 the previous month and that for non-manufacturing was 58.7 against 56.0. Both of these readings are quite encouraging. The latest figures for industrial production show the second month on month increase of 0.4% so, after April's dip, there have been three consecutive months of growth. The improvement in unemployment levels has been encouraging. Although the latest unemployment rate ticked up by 0.1% to 6.2%, there was an increase in the participation rate and job creation numbers have remained strong. The Conference Board's leading indicators rose by 0.9% in its latest reading against an increase of 0.6% the previous month. The rate of house price increases appears to have cooled down a little as measured by the S & P/Case-Shiller Composite Index of 20 cities, up 8.10% year on year in June against 9.37% the previous month. One disappointing item of data was that retail sales were unchanged in July.

What this means in terms of monetary policy is that tapering will be completed by October in the absence of anything completely unexpected. Looking at where equity markets are, with tapering nearly complete, compared with the volatility which occurred when it was first suggested by Ben Bernanke that it might happen back in May last year, we can see that investors have adjusted to it. With the US budget deficit falling, the Treasury has not had to issue as many bonds so the gradual disappearance of a natural buyer of bonds, the Federal Reserve, has neatly coincided with an improvement in the federal government's budget deficit. After tapering has been completed, the next question is the timing of the first interest rate increase which had generally been expected to be in the first part of next year. Guidance from the Federal Reserve is not easy to discern. Unemployment has been falling more quickly than expected which might seem to have implications for the size of the output gap and, therefore, inflation but Janet Yellen of the Federal Reserve pointed out in a recent speech "profound dislocations" in employment. This fairly Delphic comment has left investors none the wiser and, of course, the decision on interest rates is that of the FOMC as a whole and not just Janet Yellen, so a range of views has to be accommodated. The next challenge to the securities' markets in the USA, after tapering, will be the move towards the normalisation of interest rates. The market recovered its poise in response to tapering after two bouts of nerves beforehand and it remains to be seen how it will deal with a rise in interest rates. It

will be helpful if there is clear signalling by the Federal Reserve but, as Janet Yellen's remarks show, there is some difficulty in interpreting the data, especially in the employment market. Investors will also want to see corporate earnings growth accelerate and, in this respect, second quarter earnings growth from US companies has been encouraging. What is now needed is more revenue growth after the cost cutting and share repurchases which has helped to boost earnings. As elsewhere, the strong increase in share prices last year, which was well ahead of earnings growth, needs to be validated by faster corporate earnings growth.

We have discussed at length the problems of the eurozone so we will highlight here some of the items of data which reflect the area's difficulties. The big picture is that there was no growth in the eurozone in the second quarter and year on year growth was just 0.7%. Looking at the outcome for the four largest eurozone countries, Germany actually contracted by 0.2% in the second quarter to give year on year growth of 1.2%. The French economy showed no growth in the second quarter and barely registered any year on year growth, just 0.1%. The Italian economy contracted by 0.2% in the second quarter and, year on year, contracted by 0.3%. In the short term, the best performing economy of the four was Spain which showed 0.6% quarter on quarter growth and 1.2% year on year, admittedly from a low base. It must be a concern that Germany, the powerhouse economy of the eurozone, is struggling. In passing, it is worth noting that Germany has taken steps to handicap itself in the future as a result of decisions on pensions, intervention in the employment market and, perhaps most importantly of all, in the energy market where a knee jerk decision to phase out nuclear power looks as if it will handicap Germany, a country with high energy prices, in the longer term. The partial roll back of some earlier supply side reforms is regrettable. Demographics will also work against Germany. The latest Purchasing Managers Indices for the eurozone show a services sector reading of 53.5, slightly down from July's level of 54.2. The PMI for manufacturing fell to 50.8 but that for construction, whilst still in negative territory, rose slightly from 43.3 to 43.9. The latest industrial production figures for June for the eurozone showed a month on month decline of 0.3% and the year on year level showed no change at all. Unemployment, whilst it has fallen very marginally in the eurozone, still stands at the very high level of 11.5% with youth unemployment a major concern. The reason why investors should still retain an interest in an area with such poor economic prospects and a fundamental issue with the euro, as we indicated earlier, is that companies domiciled in the eurozone can draw on a much wider customer base in the case of those with overseas businesses. The eurozone sovereign should not necessarily be associated with the fortunes of companies domiciled within the currency area.

For Japan, the big question surrounds the success or otherwise of "Abenomics". It is too early to tell but, as time goes on, scepticism is likely to grow if the economic data is not unequivocally good. The three arrows of "Abenomics", fiscal, monetary and structural, have mostly been fired but the latter one, vitally important if the first two are to work, is in its early stages and difficult to implement. It is a high risk, high reward policy and the risk has increased with the 1st April implementation of the 3% increase in consumption tax to 8%. This may be followed by the implementation of a further 2% increase next year, although that has yet to be confirmed. The risk is, of course, that the expansionary effect of the fiscal and monetary policies will be negated by the consumption tax increase. But to say that raising the level of the consumption tax was a mistake is to ignore the precarious state of Japan's public finances where the budget deficit is expected to be around 8% of GDP this year and outstanding public debt is around 227% of GDP. If the government had just let rip with public finances, and some would argue that has already happened, international confidence in Japan could disappear. There is some protection from the fact that the vast majority of public debt is in domestic hands but not complete protection. Given the 1st April starting date for the consumption tax increase, it was certain that the economic data was going to be

distorted by this tax change and so it has proved. In the first quarter of 2014, annualised quarter on quarter economic growth was 6.1% and, in the second quarter -6.8%, reflecting the unwinding of the precautionary buying in the first quarter. At the quarter on quarter level, the first quarter 1.5% increase in GDP was replaced by a 1.7% contraction in the second quarter. The latest composite Purchasing Managers Index showed a reading of 50.2, suggesting barely any growth. Industrial production fell by 2.8% in April, rose by 0.7% in May, fell by 3.4% in June before rising 0.2% in July to give a year on year decline of 0.9%. There is, therefore, plenty of ammunition for the sceptics of “Abenomics” but it will be necessary to allow the statistics to settle down before making judgement. However, as with the eurozone, it is no good releasing a blitz of money, as the Bank of Japan has done with its quantitative easing, in isolation from structural reform which should enable the long term productive potential of the economy to increase. Structural rigidities in the labour and product markets have to be addressed and the jury is out on the latter.

The same is the case, in a different way, for China, as the government tries to move the economy away from fixed asset investment and exports towards consumption to achieve a better quality of growth, albeit at a lower rate than the double digit growth level seen in previous years. China needs a fast growth rate to maintain social cohesion in terms of providing job opportunities so it cannot afford to let growth fall too much. China has become a much more expensive country in which to do business. Employment costs have risen sharply. Whilst this boosts consumption, it affects the level of economic activity as some business moves to lower cost Asian economies. One of the major concerns is the property market, where prices have been falling sharply in many cities, and this leads to concerns about the banks if their customers suffer bankruptcies. As the world’s second largest economy, news from China is an important stock market indicator for investors. After first quarter growth of 1.4%, the second quarter growth increased to 2.0% to give a year on year increase of 7.5%. Industrial production in July increased month on month by 0.68%, just a little below the 0.77% rate of June. The latest Purchasing Managers Indices are modestly encouraging with the manufacturing index at 51.7 and the non-manufacturing index at 54.2. So, in China, investors will be monitoring the transition of the economy to its desired balance and hoping that the growth rate will not dip too much, given China’s importance to the world economy, and, secondly, they will be looking at developments in the property market which, as discussed, is the major short term issue in China.

The UK continues to be the best performing G7 economy. Second quarter GDP grew by 0.8% and the year on year increase in GDP was 3.2%. The Purchasing Managers Indices remains strong. The latest composite index stands at 58.8, that for manufacturing at 55.4, the one for services at 59.1, and the one for construction at 62.4. Unemployment continues to trend down, standing at 6.4%, and still too high, but providing a stark contrast with the level in the eurozone. Encouragingly, business investment, as in the USA, is picking up. In the second quarter, the level rose by 5.0% and the year on year increase was 10.6%. The quality of economic growth would be much improved if business investment and exports grew with consumption and housing being downgraded. However, in a very difficult international economic environment, these figures are encouraging. There are some signs that the housing market is cooling. This has been a major concern of policymakers because of the malign consequences of a boom and bust in that market. For example, the Nationwide year on year house price index rose by 11.0% in August, against a recent peak of 11.8% in June. Whilst the UK’s relative economic performance is excellent, the recovery is from a very low base and the economy has only just returned to its pre crisis level, so there is absolutely no reason for investors to be complacent. The UK is a heavily borrowed country and there remains much work to do on public finances. Although we are only four full reporting months into the current fiscal year, public sector borrowing is 5% higher than the equivalent level a year ago at £37 billion against £35.2

billion. There are reasons why these figures may not be representative of the full year but the UK has a lot of work to do over the coming years and the Office for Budget Responsibility does not forecast a surplus in public finances until 2018/2019. There are some short term headwinds for the UK economy. The eurozone is an important export market and it is inconceivable that the UK economy can derive any help from that source. The strength of sterling, although it has come off its peak a little, is making life difficult for UK companies with big export business and it affects the translation of overseas profits back into sterling. The strength of the UK economy has increased the belief amongst some observers that a rise in interest rates is not too far away. The fact that two members of the Bank of England's Monetary Policy Committee voted for an increase at its latest meeting showed that the previous consensus on maintaining the level of interest rates is beginning to fray. However, our biggest concern about the UK market is the political risk arising from the Scottish referendum in the short term and next May's General Election. We will soon enough know the outcome of the first, and a "yes" vote does not seem to have been priced into the market, but the second is uncertain although a change of government is the more likely outcome at this stage on the evidence of the opinion polls. This matters because the rise of anti business sentiment, much of it fuelled by politicians, is a serious negative for the UK economy and, if this translates into damaging policy measures, will make matters worse. There are a number of examples but the energy industry is a prime one. It has become a political punch bag. But politicians have to be careful what they wish for. The UK faces a potential energy shortage but energy company boards will not be able to justify capital investment when they are uncertain about the pricing and regulatory environment in which they may have to operate or whether they will be broken up. Foreign investors will note this. We have seen the damage that the anti business rhetoric has wrought on France and we should be watching political developments in the UK closely.

Our conclusion on markets has not changed. Although returns have been positive this quarter and for the year so far, the serious geopolitical background and the eurozone's economic woes are likely to cause setbacks along the way. Our expectations of international equity markets grinding higher during the year, with negative periods from time to time, remains realistic in our view. Although bonds have experienced a good quarter, we believe that the market is significantly overvalued. Although equity markets' ratings have risen as the market has pulled ahead of corporate earnings' growth in recent times, we believe that there remains some value against the background, as described above, which indicate to us modest returns.

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