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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Most investors were not expecting a “Leave” vote in the UK’s EU referendum on 23rd June, hence the extraordinary reaction in stock markets. However, the market outcome is not what many expected in the event of a “Leave” vote and it has been a good quarter all round, with sterling based investors experiencing exceptional returns if they hold unhedged international portfolios of securities. Equities and bonds performed well and our table of currency movements overleaf shows how violent these have been.

The tables below detail relevant movements in markets :

International Equities 31.05.16 - 31.08.16

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+2.2	+17.8	+6.0	+6.0
Finland	+3.0	+14.5	+3.0	+3.0
France	-1.0	+10.0	-1.0	-1.0
Germany	+3.6	+15.2	+3.7	+3.6
Hong Kong, China	+9.2	+21.6	+9.4	+9.4
Italy	-5.4	+5.2	-5.4	-5.4
Japan	-2.9	+15.7	+4.1	+4.0
Netherlands	+2.4	+13.9	+2.5	+2.4
Spain	-2.0	+9.0	-1.9	-2.0
Switzerland	-0.2	+12.2	+1.0	+0.9
UK	+10.0	+10.0	-1.1	-1.1
USA	+4.2	+15.8	+4.2	+4.1
Europe ex UK	+0.1	+11.4	+0.2	+0.2
All World Asia Pacific ex Japan	+7.8	+22.7	+10.4	+10.3
All World Asia Pacific	+3.1	+19.7	+7.7	+7.6
All World Latin America	+13.1	+31.8	+18.6	+18.6
All World All Emerging	+9.5	+24.5	+12.0	+12.0
All World	+3.8	+15.7	+4.1	+4.1

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +10.6%

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

Currency	31.05.16	31.08.16
Sterling	1.56	0.64
US Dollar	1.84	1.57
Yen	0.12	-0.06
Germany (Euro)	0.14	-0.13

Sterling's performance during the quarter ending 31.08.16 (%)

Currency	Quarter Ending 31.08.16
US Dollar	-9.5
Canadian Dollar	-9.3
Yen	-15.5
Euro	-9.6
Swiss Franc	-10.4
Australian Dollar	-12.9

Other currency movements during the quarter ending 31.08.16 (%)

Currency	Quarter Ending 31.08.16
US Dollar / Canadian Dollar	+0.2
US Dollar / Yen	-6.7
US Dollar / Euro	-0.2
Swiss Franc / Euro	+0.9
Euro / Yen	-6.5

Significant Commodities (US dollar terms) 31.05.16 - 31.08.16 (%)

Currency	Quarter Ending 31.08.16
Oil	-7.0
Gold	+8.0

MARKETS

International equity and bond markets have performed well during the last quarter and for sterling based investors with an unhedged portfolio of international investments there has been the added enhancement to performance arising from sterling's weakness in the aftermath of the EU referendum vote.

In local currency terms, the return on the FTSE All World Index was 3.8%, in sterling terms 15.7%, in US dollar terms 4.1% and in euro terms 4.1%. Looking at local currency performances firstly, we see the strongest performance from the UK as the international bias of large companies which are perceived to benefit from a sterling devaluation propelled many large companies' share prices upwards. The FTSE UK Index returned 10.0%. Elsewhere, there were strong performances from the FTSE All World Latin America Index (+13.1%), the FTSE All World All Emerging Markets Index (+9.5%) and the FTSE All World Asia Pacific ex Japan Index (+7.8%). The FTSE USA Index put in a slightly above average performance (+4.2%). Underperformers were the FTSE Japan Index (-2.9%) and the FTSE Europe ex UK Index (+0.1%). Because of the weakness of sterling, the picture changed dramatically in sterling terms with the FTSE UK Index underperforming the sterling adjusted FTSE All World Index. The best performers in sterling terms were the FTSE All World Latin American Index (+31.8%), the FTSE All World Emerging Markets Index (+24.5%) and the FTSE All World Asia Pacific ex Japan Index (+22.7%). Because of the strength of the yen, the underperformance in local currency terms became an outperformance in sterling terms with the FTSE Japan Index returning +15.7%.

In international bond markets, as measured by ten year benchmark government bond yields, the fall in yields was dramatic. In the UK government bond market, the yield fell by 92 basis points to 0.64%, in the US Treasury bond market by 27 basis points to 1.57% and in the German Bund market by 27 basis points to -0.13%. Only in the Japanese government bond market did the yield rise, although from negative to less negative by 6 basis points.

Post the Brexit vote, moves in the currency market were dramatic. Against the yen, sterling fell by 15.5%, against the Australian dollar by 12.9%, against the Swiss franc by 10.4%, against the euro by 9.6%, against the US dollar by 9.5% and against the Canadian dollar by 9.3%.

In the commodity markets, oil, as measured by Brent crude, fell by 7.0% whilst gold rose by 8.0%.

ECONOMICS

The international economic background continues to be surreal with monetary policy at the extreme limits of what most economists can ever have imagined possible, with these limits becoming even more stretched following the Bank of England's additional monetary measures, including further quantitative easing. In the international fixed interest markets, as this is written, there are approximately US\$13 trillion of bonds standing on negative gross redemption yields meaning that, if one bought the bonds now and held them until redemption, one would certainly lose money in nominal terms and, assuming some level of inflation, lose even more in real terms. The word "unbelievable" is much overused these days, especially in the sporting field, but the word is quite appropriate to describe a monetary background which has propelled bond and equity prices to peak levels in most bond and some equity markets.

This means that many sterling based investors' portfolio returns so far this year have been far in excess of what we had expected at the start of 2016. Of course, there are still four months to go so,

in this year of surprises, much can still happen but we can note for the moment that markets are relatively calm with, in equity markets, very low levels of volatility. At the beginning of the year, our expectation, as outlined in our December review, was that international equity markets would grind higher over 2016, but with some difficult times reflecting the troubled economic and political background. So, we expected a positive equity return this year but nothing like the return which has so far been achieved. Emphasising again the very important qualification that there is still one third of the year to go, during which much can happen and therefore the year end result cannot be taken for granted, it is worth trying to understand what has happened in markets so far this year, starting with bond markets.

If we take the ten year government bond yields, which we show in our monthly economic reviews, as a benchmark and compare gross redemption yields now with what they were at 31st December 2015, the extraordinary developments in the bond markets become quite apparent. The ten year UK gilt then yielded 1.96%, now it yields 0.64%. The US Treasury yielded 2.27%, now it yields 1.57%. The Japanese Government Bond yielded 0.27%, now it yields -0.06%, whilst the German Bund yielded 0.63% and now it yields -0.13%. What is going on and how can one possibly justify holding a security which is bound to lose money if held to redemption, let alone buying one? It is happening because the central banks of the eurozone, Japan and, now, the UK again, are big purchasers of fixed interest securities as part of their quantitative easing programmes. Yield appears to be irrelevant as they try to stimulate their respective economies by flooding them with cheap money to encourage business to invest and consumers to spend. Despite large budget deficits in Japan, the UK and some eurozone countries, the scale of the central banks' buying has been so large that there has been a shortage of suitable bonds to buy in some instances. One might think that a rational investor would jump at the chance to sell bonds to their central banks at or below current yield levels but many international investors have to hold bonds for regulatory or liability matching reasons, hence their reluctance to sell. That is a major technical reason supporting current yield levels, but can there be fundamental reasons as well to do with the apparent attraction of bonds at very low or negative yields? If one believes that the outlook is one of persistent deflation then even a negative nominal yield can still mean a positive real yield. Whilst it is true that Japan and a small number of EU countries might record price falls this year, the majority of countries will show very modest inflation rates. We find it difficult to believe that the world economy is going to experience years of other than isolated deflation. Indeed, central banks are trying to use monetary policy to achieve modest levels of inflation, typically around 2%, as a way of nullifying some of the malign effects of deflation, one of which is to discourage discretionary expenditure in the hope that the goods can be purchased more cheaply later on, thus creating a vicious circle of declining demand and recession. One of the reasons for current very low inflation or deflation levels is, of course, weak commodity prices, particularly for oil, but with a growing world economy, even at very modest levels, it is hard to see prices remaining permanently depressed. Food prices, which have also been weak but are now recovering, and are subject to conditions beyond human control like the weather, are unlikely to be permanently weak. We think this deflation reason for buying or holding bonds is not valid. Another possible reason is that an investor feels alternative investments are so dangerous that it is better to achieve safety, say through government bonds issued by a highly creditworthy sovereign, even if it involves a negative yield and therefore a loss if held to redemption. For such an investment to be preferred, shares would not be up for consideration and cash at the bank, even if there was a slightly better return, would be considered risky because of doubts about the banks' solvency. In most countries, this would seem to be an extreme view to which we would not subscribe. Although we would not agree with the argument about shares, our favoured asset class, we can understand it but, in those circumstances, we would favour cash over fixed interest securities. When yields rise, as they will at some stage, there are going to be some significant price falls in bonds which, unlike in the case of equities, will probably never be recovered. If an investor excludes equities from consideration, and ignoring property, then at least cash gives flexibility. To our mind, the risk/reward ratio of holding bonds, unless one is obliged to, is extremely unattractive and the further along the yield curve one travels, the larger are likely to be the losses. It is in these circumstances that, in the search for yield, investors take on more risk in the bond market, by buying lower quality bonds. This is evidenced by a narrowing of the spreads between

junk bonds and investment grade credits as well as the fall in absolute yields. The question is whether the level of defaults provides a good trade off with the enhanced yield on these bonds. The spread of US speculative grade bonds (the yields on this class of bonds against the risk free rate) is down to 534 basis points and, for European speculative grade bonds, 405 basis points. The danger here is not only the level of risk being taken on with the credits themselves, but also that some big upset to confidence in international markets, say in emerging markets but it could be other events, causes the yield spread to widen again in the face of a renewed rush to quality.

What perhaps gives bondholders comfort is that, for the foreseeable future, the interest rate environment is almost certain to remain benign. There is hardly any chance of interest rates being raised in the UK, eurozone or Japan and the possibility that they may be lowered further. In the USA, the current level of interest rates is below what was expected at this stage at the beginning of the year. The expectation was that there would be five small interest rate increases this year but, for one reason or another, they have not materialised. There is the expectation, however, that there will be an increase before the year end but the timing will be complicated by November's elections for, although independent, the Federal Reserve would not want to be accused of influencing the election campaign by raising interest rates close to polling day. However, the increase, as and when it is made, will be small and should not come as a shock to the market.

However, this sugar rush in the fixed interest market caused by cheap and newly created money must not be in danger of being considered a permanent boost to fixed interest or equity markets, or one which will provide prices with permanent support. Only a few years ago, the idea that all the main central banks would, at one stage or another, be creating money to buy government and corporate bonds would have been considered extraordinary. After all, if money is created out of thin air and is chasing a finite amount of goods and services, then surely this is storing up big inflationary problems for the future? It is even more fantastical that there is now talk of "helicopter money" being used to try to stimulate economic growth. This is one stage further than quantitative easing. With the latter, the central banks' balance sheets are being swollen as the central bank creates money electronically to buy bonds off the private sector with the hope that the resulting cash paid to, say, banks, will find its way round the economy as it lends money for investment or consumption. As a footnote, this will depend upon the money circulating round the economy rather than being parked for lack of demand, which is what appears to have happened. The point about quantitative easing is that, in theory, it can be reversed and the central banks' balance sheets shrunk again so that the inflationary risks of the original quantitative easing can be reversed. As and when that happens, the presence of a large seller of bonds in the market (the relevant central bank) would normally be expected to push up yields and, therefore, prices down. The possible positive implication for bondholders, to offset the technical one just mentioned, is that it should reduce the risk of inflation caused by maintaining the central banks' balance sheets at elevated levels. However, "helicopter money" is a stage further and really would indicate desperation on central banks' behalf because here the newly created money cannot be withdrawn and one metaphorically envisages a helicopter showering money over a community with the banknotes being picked up by the residents and spent on purchases, thus creating more economic activity. Of course, it would not happen this way. More plausibly, it could mean that members of the population are credited with funds in their bank accounts or the funds are used for major infrastructure projects, to give two examples. However, the difference here with quantitative easing, as so far practised, is that this newly created money cannot be clawed back and has the potential to debase the currency and cause serious inflation. Secondly, once spent, its main effect is over and may have to be repeated, which would be even more dangerous. One hopes that it does not come to this. What all this leads up to is how potentially dangerous the bond markets are at these levels. We have explained how it has come about that yields are so low or negative because of quantitative easing. We distinguish between those investors, mainly institutions, which have to hold bonds for regulatory, liability matching or other reasons, and those who are under no investment constraints but who think that, for one reason or other, bonds are suitable investments at this level. The short end of the market is low risk in the sense that positive or negative returns would be small but, the further along the maturity spectrum one goes, the greater the risks become. It will be a dangerous time in bond markets when

investment sentiment turns and investors rush for the door. Regulatory constraints have reduced liquidity in the markets and price movements could well be sharp. Fundamentally, one cannot justify these yields. Real yields are significantly negative in many eurozone markets, a cause for concern.

Now, we turn to equities, which have shown a mixed pattern in local currency returns so far this year, but ahead overall, and exceptionally good returns in sterling terms as the currency has weakened following the EU referendum result. At the time of writing, the total return in local currency terms is around 7%, a very acceptable performance in this very low inflation environment. Probably the main reason for the rise in equity prices is the search for yield in this ultra low, or negative, interest rate environment by investors who are prepared to hold equities even though they may not have been traditional holders of this asset class. The extreme monetary policy being followed at present has meant that, contrary to most of recent history, equity dividend yields exceed those of government bonds, taking ten year maturities as the benchmark. To give a few examples, the S & P 500 has a dividend yield of approximately 2.1% against 1.57% for the bond, the Euro Stoxx 50 has a dividend yield of 4.05% with the relevant yields in German, French, Italian and Spanish bonds, to name the four largest eurozone economies, well below that and, in the case of German Bunds, negative. In the UK, the FTSE 100 Index shows a dividend yield of approximately 3.7% and the UK gilt 0.64%. In the case of Japan, the dividend yield is around 2.0% against -0.06%. These are not small differences and, in times of very low inflation, represent real yields, so equities certainly have an appeal for some yield starved investors. As share prices have been driven upwards by cheap money and the search for yield, they have become more expensive in terms of p/e ratios given modest growth in the world economy and subdued earnings reports. However, notwithstanding our comments about the dangers for bond holders when interest rates rise, this is not a short term prospect, given the stance of monetary policy, so the attraction of equity dividend yields is likely to remain and we must, at this stage, just note that some equity markets are quite highly rated at a time when world economic growth prospects are modest.

Now, we turn to the position of sterling based investors. The most significant event during the quarter has been, of course, the EU referendum majority vote for the UK to leave the EU. Two months after the vote, the most significant market event has been the fall in sterling, although the fall in bond yields and subsequent recovery in the UK equity market have been notable. This has meant that sterling based investors with significant overseas exposure in their portfolios which was not hedged, have seen a quarter of high investment returns. A prudent investor will always spread his or her risk and one of the important ways of doing this is to spread the geographical risk, and not to hedge it, unless there is a very good reason to do so. It is important to remember that the UK equity market accounts for less than 7% of the world's market capitalisation, whilst the USA accounts for over 50%. We do not hug index weightings but do believe it important to spread a portfolio's assets throughout the world. At the moment, rightly or wrongly, the UK is considered quite a high risk country simply because no one knows how Brexit is to be achieved and what will be the consequences. This is not to pass judgement on whether it will ultimately prove to be a wise or unwise move for the UK to leave the EU, only time will tell, but to state the obvious that the UK is facing a period of uncertainty. Therefore, a heavily UK centric portfolio means even more concentration of risk. So, in the last quarter, the greater the unhedged overseas exposure for sterling based investors, the better the return, whilst, in a portfolio's UK section, many companies with large overseas businesses have performed well. Overall, despite underperforming many overseas markets in sterling terms, the FTSE 100 Index has still put up an excellent 12% return so far this year to the end of August. It is also notable that, despite all the political and economic problems which one had anticipated at the beginning of 2016 affecting the world, the markets, after a difficult start, have largely ignored them. This is in no way to be complacent but markets seem to be becoming inured to the dreadful events we see on the television screens every day.

Turning to what sterling based investors should do in the aftermath of the EU referendum result, the spreading of investments geographically and remaining unhedged is paramount in our view. That provides a lot of cover for the uncertainty of the position by spreading the risk. One very obvious area

of continuing attention is sterling which has fallen significantly since 23rd June (about 10.2% on a trade weighted basis to the end of August). That is natural. From an economic perspective, this leads to some loosening in economic policy since, although there are obvious downsides from a weaker currency, it should provide some stimulus to the economy through more competitive exports, visible or invisible. One early example of this might be the UK tourist industry and retailers in areas such as London which draw large numbers of foreign visitors attracted by the lower value of sterling. Whilst the UK economy has been performing well in a number of areas in recent years, it does have fundamental weaknesses which need to be addressed and which, as we have often pointed out in past reviews, have the potential to destabilise sterling. The twin deficits, current account and budget, are an issue for the UK which has an unbalanced economy. Pre Brexit, although sterling had started to weaken, the markets seemed not to have been unduly worried about the imbalances in the economy but, now, much more attention will be paid to them and sterling could suffer. The size of the current account deficit is much too large for comfort. In the first quarter of the year, it was running at 6.9% of GDP. It is true that the trade deficit component of the current account deficit has been fairly stable at around 2% and that the deterioration has occurred because the earnings from the UK's stock of overseas assets (primary income) have turned negative on a net basis. However, a current account deficit that large has to be financed by foreign inflows of capital and it is, therefore, necessary for the government to do everything possible to make the UK an attractive place for foreign investment. In some ways, the UK has become a much less attractive place for foreign investors. Politics got caught up with economics in some areas, the housing market being one of them. The UK and London, in particular, are much less welcoming for foreign investors in the area of property and this is being seen in prices and activity at the top of the London housing market. With the UK having such a poor current account situation, the UK has to be attractive to foreign capital. There are good signs. The UK is one of the most open economies with far fewer hang ups about foreign investment coming into the UK. At a time when, regrettably, protectionism is on the rise, it is to be hoped that the UK does not go down that route. Some talk about making foreign takeovers more difficult is not sensible when the UK needs to attract as much foreign capital as possible. So, investors need to keep an eye on the politics in the UK as well. The other part of the twin deficits, the budget deficit, is likely to become more problematical post the EU referendum vote. Pre the Brexit vote, it was becoming doubtful if the Chancellor's target could be met, now it looks very doubtful, so the new Chancellor has talked about resetting fiscal policy, with the 2020 target for balancing the budget already formally ditched. This makes sense given the uncertainty which will surround the UK economy over the next few years. In fact, it is part of a trend where fiscal policy is being quietly loosened against targets, the eurozone being a case in point where Spain and Portugal have been given more leeway by the EU on their budget deficits. France will miss its target and Italy wants a respite as well, which it might receive in front of a crucial referendum on the constitution in the autumn which, if he loses it, Mr Renzi says he will resign. As the main opposition, the Five Star Movement, wants to call a referendum on Italian membership of the euro and, given the problems in the Italian banking system, Italy may have more leverage with the EU than people imagine. Looser fiscal policy in the UK makes sense but it is important that the medium term target of a balanced budget is adhered to given the poor state of public finances. If it were to appear that it was getting out of control, sterling could also suffer given the amount of gilts in foreign hands (about a quarter of the total). Currency forecasts are notoriously difficult to get right but, in view of the background described above, it is difficult to imagine sterling being a strong currency, so the importance of unhedged geographical diversification is underlined.

Some of the gainers from sterling's devaluation post the referendum are obvious and this has been reflected in the relative outperformance of the FTSE 100 Index against the more domestically orientated FTSE 250 Index. The majority of business for FTSE 100 companies derives from overseas, about 70% it is estimated, and therefore the value of overseas earnings is enhanced when converted back to sterling. In traditional economic theory, a devaluation initially worsens a country's trade deficit as imports become more expensive and export or import substitution effects take time to work through the system. Once they have done so, the trade account starts to improve as exports grow and home produced goods start to replace some imported goods as the substitution effect starts to take place. In such a case, UK exporters and manufacturers of price sensitive goods would be expected to

benefit. The other option is for UK manufacturers to maintain their foreign currency prices for exports and not chase volume but, instead, to aim for higher profit margins. In choosing companies in which to invest, investors should look for the beneficiaries of devaluation. On the other hand, UK companies which import goods either to sell or as inputs for what they manufacture may face competitive pricing pressure and find their profits under pressure. But, intuitively, one feels that this “J curve” theory as it is called because, initially, the trade deficit worsens (the dip in the “J”) and then improves (the move upwards from the bottom of the letter “J”) needs to be questioned increasingly in this modern economic age. In an era where countries competed in relatively low value added goods, which could not be differentiated easily, price would be important. Nowadays, as many countries’ manufactured goods are of the higher value added variety, price is less important, so the traditional effects of devaluation, as outlined in the “J curve”, are less obvious. Furthermore, the UK is predominantly a service orientated economy with manufacturing accounting for only about 11% of the economy. These services, such as those offered by the professions, are usually highly specialised and therefore less price sensitive. Certainly, the experience of recent years for the UK, after the significant sterling devaluation in 2008, does not suggest that the UK benefited from devaluation on its trade account. From an investment selection aspect, it is important to hold UK companies which will benefit on an individual basis from devaluation.

The conclusions we can draw about the stance to take on Brexit from an investment point of view at this very early stage are that, because of the very loose orthodox and unorthodox monetary policy which is likely to continue in the UK and probably pushed further and looser than previously forecast fiscal policy, the pound may well fall further, particularly in the light of the very large current account deficit. We are usually very loath to make currency forecasts, which are notoriously difficult, but there seems no obvious reason for sterling to rise and therefore the balance of probability is that it will fall further. This argues for two investment themes, one general and the other, particular. The general one, even in more normal times when Brexit was not considered, is to spread the risk geographically and the particular one, within UK equity exposure, is to have important exposure to the overseas earners. In the sterling fixed interest market, notwithstanding the factors supporting it, i.e. further quantitative easing and interest rate cuts, investors must not be lulled into a false sense of security. Especially after sterling’s post referendum devaluation, deflation is a very unlikely prospect for the UK and the yields being offered on fixed interest securities are a long way from being anywhere near realistic. If equities were to fall, they are likely to recover at some stage and move ahead but one cannot say this about bonds and there is very unlikely to be a happy ending.

Finally, before we leave particular short term issues surrounding the EU referendum result, we should emphasise that these comments do not reflect a judgement on whether Brexit will be beneficial or harmful for the UK in the long term. We will not know for a long time. Secondly, no one should assume that there will be little effect on the remaining EU member countries. Once a precedent has been set, electorates in other EU countries may press for their own referendums, whether it be on EU membership or, say, membership of the eurozone. It may expose further fault lines in the euro whether it be caused, for example, by the Italian banking system or budget deficits which cannot be brought under control or further problems for Greece. With a large trade deficit with the rest of the EU, the UK is an important export market for a number of EU countries and any weakness in the UK economy could be expected to have an impact on these countries’ exports. At the margin, this might slow down economic growth in the EU.

Turning from the particular issues for sterling based investors arising from Brexit, we can now look globally at the economic outlook. In July, the IMF published its latest World Economic Outlook update which took into account its view of the short term economic implications of the UK’s EU referendum result. Compared with its April 2016 WEO, it reduced its latest projections for world economic growth in 2016 by 0.1% to 3.1% and for 2017 by 0.1% also to 3.4%. As far as Advanced Economies were concerned, the IMF reduced its forecast by 0.1% to 1.8% for 2016 and by 0.2% also to 1.8% for 2017. Within the Advanced Economies sector, the IMF downgraded the 2016 growth forecast for the USA by 0.2% to 2.2% but left its 2017 forecast unchanged at 2.5%. It actually

increased its forecast for the eurozone by 0.1% this year to 1.4%. The main reason for the upgrade this year in the eurozone was a 0.4% increase in its forecast for French growth this year to 1.5%. Given the very disappointing level of growth in the strike affected second quarter in France, it may be difficult to achieve this level of growth. The four largest eurozone economies have all seen their growth forecasts cut for 2017, with the largest being for Germany with a 0.4% reduction to 1.2%. Elsewhere, its prognosis for Japan is fairly bleak. The IMF has reduced this year's forecast by 0.2% to 0.3%, although it has raised it by 0.2% next year to 0.1%. Following the UK's Brexit vote, it has taken the knife to the UK's growth forecasts. For this year, it is a modest 0.2% reduction to 1.7% but, for 2017, the forecast has been reduced by 0.9% to 1.3%. For Emerging Markets and Developing Economies, it has left both years' forecasts unchanged at 4.1% and 4.6% respectively. Within that category, it has slightly raised its forecast for China to 6.6% this year, an increase of just 0.1% over its April forecast, and left next year's forecast unchanged at 6.2%. It has trimmed the projection for India for both years by 0.1% to 7.4% in 2016 and the same again in 2017. Whilst the two other members of the original BRIC economies, Brazil and Russia, are experiencing very difficult economic times, the IMF has raised its forecasts for both countries for both years. Brazil, still seriously in recession, has its forecast raised by 0.5% for both 2016 and 2017 to -3.3% and 0.5%, whilst Russia's forecast was raised this year by 0.6% to -1.2% and by 0.2% for next year to 1.0%. The IMF's forecast for consumer prices is that they will rise by 0.7% this year and 1.6% next year, slightly higher by 0.1% than in its April forecast. The projections for Emerging Markets and Developing Economies have been slightly raised by 0.1% this year and 0.2% next year to 4.6% and 4.4% respectively. Obviously, forecasts will not always be right but, assuming the inflation forecasts are anywhere near accurate, it does throw into perspective the vast amount of fixed interest investments standing on negative nominal yields and even bigger negative real yields. The IMF's forecasts therefore remain for very modest growth, not much above what economists call stall speed, but in an era of historically very low inflation. They are consistent with a world economy muddling through some very difficult political and economic conditions but still nevertheless showing some growth.

Turning from the general to the particular, we now look at the news from individual countries and areas, starting with the USA where, after the UK's EU referendum vote, the next big political event occurs, the US elections, with all eyes turned on the result of the Presidential election, although congressional elections will be very important given the checks and balances in the US constitutional system, which could be more relevant than usual on this occasion. For investors, the political prospects may not look very enticing and, in some respects, quite alarming. The political centre in the USA has been largely vacated. The Democrats have been pulled leftwards and this is reflected in Mrs Clinton's policy stances in some areas, rather different from her husband's centrist policies when he was President, whilst the Republican candidate's policies are hard to place and certainly not traditional Republican ones which investors might normally favour. Some of the proposals are downright dangerous, such as those to place punitive tariffs on some Chinese imports which could spark off a trade war, which could trigger an economic recession or even depression. Whilst neither candidate will elicit enthusiasm from Wall Street, the insouciance of the US stock market at present suggests, as seems likely at this stage, that Hillary Clinton will win the Presidency but may be stymied in Congress by the Republicans. A cynic might suggest that, if the system of checks and balances between the executive and the legislature results in stalemate, the result might be the best one for the economy, which can progress under its own steam. There is something to be said for this line of argument.

Whilst the expectation of at least one interest rate rise in the USA is growing, the data coming from the USA is mixed. As we saw earlier, the IMF has reduced its growth forecast for the USA this year by 0.2% to 2.2%. The GDP data has been disappointing. Second quarter annualised growth was 1.1% after 0.8% in the first quarter and year on year growth was 1.2%. Durable goods orders were disappointing with the latest figures for July showing a month on month decline of 4.4% and a year on year decline of 4.2%. Consumer confidence figures for the last two months have been below those for May and June. The employment data, apart from what appears to have been an aberration in May, has been quite robust with non farm payrolls increasing by 272,000 in June, 275,000 in July and 151,000 in August, with the unemployment rate holding steady at 4.9%. The Labour Force Participation Rate,

an important piece of data to be read in tandem with the unemployment rate, has been trending upwards, standing at 62.8% in August compared with 62.6% in May. This is still a low reading which tends to flatter the impression shown by the unemployment data, but there is still encouragement to be drawn from the trend. The important Purchasing Managers Indices were mixed. That for manufacturing stood at 49.4 (52.6) in August, whilst that for non manufacturing stood at 55.5 (56.5). Housing data mainly points to a modest improvement in the market. The Conference Board's Leading Indicators showed an improvement of 0.4 in July following one of 0.3 in June, which reversed the previous month's decline of 0.2. The figures for capacity utilisation have been creeping higher and, in July, reached 75.9%, a full point higher than in May. Factory orders have been rising month by month. Core inflation, as measured by the Personal Consumption Expenditure (PCE) Index, which is watched closely by the Federal Reserve, has been steady at 1.6% year on year, with the last reported month on month rises of 0.2%, 0.2% and 0.1%. The Consumer Price Index stands 0.8% higher than a year earlier. Whilst inflation is, of course, historically low, a federal funds rate of 0.375% in normal circumstances is not consistent with the overall thrust of the data coming out of the USA. The Federal Reserve has to be thinking about what it will do when the next recession comes about because it has to have some monetary ammunition, which it does not have at present, given the very low official interest rates currently prevailing.

As we said earlier, share prices, which are at around record territory on Wall Street, are, as elsewhere, being supported by ultra low interest rates and bond yields which make shares' dividend yields look attractive. In the USA, corporate earnings have declined on a year on year basis for five quarters in a row. The situation whereby share prices in the USA have risen strongly this year, corporate earnings have declined and inflation is very subdued, cannot continue indefinitely. The expectation is that the position will turn itself round soon with corporate earnings starting to show quarterly growth. It should also be borne in mind that corporate earnings have been assisted by large share buy backs as companies deploy surplus cash or borrow money at unmissable rates to effect buy backs and enhance earnings per share. The hope is that, when earnings start to improve and the big earnings fall from the energy sector is out of the way, companies will start to invest more aggressively. Notwithstanding the negative issues for Wall Street and its good performance relative to most markets this year, we continue to believe it to be one or more of the safer markets in which to invest. As November approaches, all eyes will be on the election. At the moment, the market is discounting a Hillary Clinton win, but, if the opinion polls tighten again and Donald Trump looks as if he has more than an outside chance, the market may show some nervousness. That is not our central case at present.

Moving on now to the eurozone, the growth rate for 2016 projected by the IMF at 1.6% is slightly below the 1.7% achieved in 2015. Apart from Germany, the main members of the eurozone are showing budget deficits. The best way of attacking the budget deficit and overall borrowing ratios is to achieve higher economic growth, but this is clearly proving elusive. For the most troubled members of the eurozone, the potential long term growth rate of their economies is poor. This is for a number of reasons. One is that heavy levels of debt cramp an economy's growth prospects. The country's finances are weighed down by the interest burden making it difficult for fiscal policy and perhaps monetary policy to act as a stimulant to growth. Another reason, very prevalent in Europe, is the inflexibility of their economies, particularly in the labour market. Heavy regulation is a discouragement for employers to take on staff and structural rigidities weigh on a country's growth potential. We noted that France has shown no growth in the second quarter of 2016 and an important reason was that the economy was adversely affected by significant strike activity triggered in, some cases, by a very modest relaxation of employment law. If labour and product markets cannot function properly, growth prospects are damaged and, for countries which have a debt problem, it makes dealing with it very hard. The cracks in the edifice may well be widened as the process of the UK disengaging from the EU highlights the fault lines in the euro. The latest data from the eurozone shows that second quarter GDP grew by 0.3% compared with the previous quarter and by 1.6% year on year. On a year on year basis, the star performer amongst the four largest eurozone economies was Spain at 3.2% and a quarter on quarter increase of 0.7%. The next best was Germany with a year on year increase of 1.8% and a quarter on quarter increase of 0.4%. Then came France with a year on year increase of 1.4% but, as mentioned

above, no quarter on quarter increase. Italy, a significant concern because of its high level of debt and large exposure to bad loans in its banking sector, only grew by 0.7% year on year and, like France, showed no growth in the second quarter of this year. The important purchasing managers indices are mildly positive for the eurozone as a whole. The latest figures show a reading of 51.7 for manufacturing and 53.1 for services. Not surprisingly, the strongest readings overall came from Germany with the manufacturing index at 53.6 and the services index at 53.3. The weakest readings came from France, affected by terrorism and strikes, with the manufacturing index reading at 48.3 and the services index at 52.0. Industrial production in the eurozone is only slightly up year on year at 0.4% and again the weak readings are from France and Italy at -1.3% and -1.0% respectively. Consumer confidence in the area seems low with the latest reading at -8.5. Unemployment, although it has been falling slightly, still stands at the very high level of 10.1%. Adding in all the political difficulties makes it hard to see a way forward in the important policy area of accelerating economic growth.

What more can be done to stimulate growth in the eurozone? As elsewhere, it is hard to see that monetary policy can contribute much more. The ECB can arrange to buy as many bonds as it can to drive down interest rates and provide plenty of liquidity, but there has to be the urge to borrow and invest by businesses, and the magnitude of the fall in interest rates at current levels is so small that it is difficult to imagine that it can tip the balance on marginal projects. Negative interest rates are generally undesirable because they have unwanted side effects. For banks, they are a threat to their profitability for it is difficult to charge customers for holding deposits and, with problems in some areas of the eurozone banking sector, now is not the time to be aggravating the profitability prospects of banks. As everywhere else, the distortions caused by the current interactions of monetary policy need to be unwound at some stage. Besides problems for banks just mentioned, it is a further reason, over and above those already mentioned, why the long term growth rate of an economy can be harmed. Zombie companies kept afloat by cheap money crowd out new or established businesses with better growth prospects which damages economic growth. There is also the damage that low or nil interest rates do to the savings market. It encourages some investors to take riskier bets in the search for yield. In so far that these do not turn out well, collateral damage is done to an economy. We talked about how credit spreads on low grade debt had narrowed in the search for yield. When interest rates rise, either because of official action or because some event causes a flight to quality, any distress in this high yield credit market could cause economies damage. So, whilst an important part of the negative yield bond universe resides in the eurozone as well as some non euro member EU countries, investors need to take on board that negative interest rates are not necessarily good news for them. It is a sign of desperation that monetary policy has had to be stretched so far. Probably the next event in the eurozone for investors to be aware of as far as it affects investment in the eurozone is the Italian constitutional referendum in Italy in November. As the third largest member of the eurozone suffering from high debt levels, no growth, substantial bad loans in the banking system and political uncertainties, it is a potential fault line in the eurozone.

As the IMF forecasts show, Japan has shown very disappointing growth and, if its forecasts for 2017 are anywhere near correct, there will not be much joy in 2017. Here again is an example of extreme monetary policy measures being taken but, so far, without much success it would now seem. The substantial quantitative easing programme of the Bank of Japan has included large purchases of equity exchange traded funds. In July, it said that it would increase ETF purchases so that their amount outstanding will rise at an annual pace of JPY6 trillion (US\$56.7 billion) from JPY3.3 trillion previously. The latest GDP data was very disappointing with latest annualised growth in the second quarter of 2015 at 0.2% and year on year growth at 0.6%. The first quarter growth rate was revised to 2.0%. Japan is trying negative interest rates in an attempt to lower the value of the yen and help to achieve the Bank of Japan's 2% inflation target, but the yen has not responded and has remained stubbornly strong and the yen's effective exchange rate has risen over 17% so far in 2016. Competitive interest rate reductions which attempt to lower a currency's value end up as a zero sum game. The Bank of Japan and the government want the yen to be weaker to encourage spending and stimulate economic activity. If, as in the past, consumers and businesses are in a deflationary mindset, they will not be encouraged to spend and thereby stimulate economic activity. Furthermore, as far as Japanese

companies are concerned, a high volume of the yen is not good for corporate profits and leaves them disinclined to invest. The first three arrows of Abenomics are monetary, fiscal and structural. The monetary arrow is the one which has been pressed hardest, with a vast level of quantitative easing being employed by the Bank of Japan. Fiscal measures have to be more constrained because of the poor state of Japan's public finances, both in terms of the budget deficit, likely to be around 5.0% of GDP this year, and the gross level of public debt in relation to GDP, around 240%. However, in response to the sluggish state of the Japanese economy, a new stimulus package was announced in August amounting to new government spending of JPY6.2 trillion of which JPY4.6 trillion (US\$45 billion) will fall in this fiscal year, amounting to 0.9% of GDP. It appears that monetary policy practised in its extreme form, as at present, with negative interest rates and vast Bank of Japan securities purchases, must be coming to the level where it is ineffective and potentially dangerously large. With its own exchange rate and the majority of public debt held domestically, Japan faces less risk of a loss of international confidence, but it could happen if monetary policy looseness is extended too far. It is interesting to note that the Governor of the Bank of Japan, Haruhiko Kuroda, has ordered what is described as a "comprehensive assessment" of the economy and the effectiveness of the Bank of Japan's policy. The attempt to reach its 2% inflation target has been unsuccessful so far. Year on year consumer prices are 0.4% lower with the latest month on month figures, showing a decline of 0.2%. Core consumer prices are, however, modestly in positive territory, 0.4% up year on year. Most of the data coming from Japan recently has been negative. The purchasing managers indices are hovering around the 50 mark, with the composite index at 49.8, the manufacturing index at 49.5 and that for services at 49.6. These figures are consistent with the GDP data from the second quarter. Consumer confidence at 41.3 is low and this shows up in the data for year on year retail sales which are 1.3% down year on year. Industrial production is 1.5% lower year on year. Finally, the Tankan survey shows a weaker position, with the latest reading being at 4 compared with 7 previously. The paradox is that, for sterling based investors with unhedged exposure to the Japanese equity market, the returns so far this year have been near the best of the major international equity markets, only a little behind the USA but, in local currency terms, the equity market has been one of the worst performers with a significant negative return. Even though the economic prospects look unpromising, the issue for equity investors is the same as elsewhere. Asset prices have support from monetary policy and, in the case of Japan, official support for the equity market through the purchase of exchange traded funds. With the ten year JGB showing a negative gross redemption yield, a 2% dividend yield on the Japanese equity market looks appealing and, given that Japan is experiencing deflation, the real yield is even higher. The Bank of Japan's review of the effectiveness of its policy might provide a better guide to the market outlook. Meanwhile, weighing up the positive and negative arguments for Japan leaves a neutral view in the market on the current information available. It is the same type of background which has produced very good returns for sterling investors this year whilst local investors have had a disappointing experience.

Although not influencing markets like it did a year ago when the 1.9% reduction in the value of the renminbi, as China widened its trading band for the currency, caused significant volatility in markets, investors' eyes remain firmly on China as it tries to make the transition from fixed investment and exports to consumption and bolstering of the services industries. The latest GDP figures for the second quarter show quarter on quarter growth of 1.8% and year on year growth of 6.7%. As it makes the transition, a slowing down is inevitable so it is a question of being able to manage the move successfully. The currency is now measured against a basket of currencies, not just the US dollar, and it has been falling against the US dollar (falling 3% this year so far), this time not creating the alarm in the markets which it did a year ago. The purchasing managers indices do not paint a picture of rapid growth but are not bad. The latest index for manufacturing stands at 50.4 whilst that for non manufacturing stands at 53.5. Industrial production is 6.0% higher than a year ago and retail sales are 10.2% higher than a year earlier, to give a sample of data pointing to an economy which is slowing down slightly, as one would expect. Meanwhile, China continues to open up its domestic stock market further, with the opening of the Shenzhen Connect link to complement the Shanghai link. For international investors, stocks traded on the Shenzhen market are likely to be considered more interesting than those in Shanghai, which feature state owned companies as opposed to more exciting

technology stocks on the Shenzhen exchange. Politically, China remains a sensitive area for investors. Concern about the commitment to market reforms is an issue for foreign investors, whilst China is concerned about increased signs of protectionism abroad, the USA and, more recently, Australia, for example, not to mention a review of the Hinkley Point nuclear power project in the UK which involves Chinese investment. One of the biggest threats to the world economy is protectionism. A slowing down in world trade caused by tariffs and quotas being applied, or increased, reduces consumers' welfare as distorted trade patterns increase prices and reduce disposable incomes. This is why investors will be paying close attention to the forthcoming US Presidential election and China is central to this.

As far as the UK is concerned it is, as we said earlier, very early days regarding the implications of Brexit. We have discussed some of the issues and there will be many more. The most obvious effect of the EU referendum vote has been on sterling and we indicated that, whilst currency movements are very difficult to forecast correctly, it is difficult to see why sterling should rise from its post referendum levels and may fall further, citing reasons like looser monetary policy and a weak current account. Such data as there has been since the 23rd June has been mixed but it would be wrong to pay too much attention to it because some of it relates to the period before the vote and post Brexit data might represent a knee jerk reaction which may not follow through. Not unexpectedly, the purchasing managers indices initially fell heavily but, although an important set of data, on this occasion the figures may relate to the shock of a "Leave" victory rather than setting a trend. However, August's manufacturing PMI has bounced back sharply to 53.3 from 48.3 in July. Consumer confidence fell heavily but, again, this may be temporary as consumers see that little has changed in the short term. The latest reading for July was - 12 against - 1 in June. On the other hand, the employment data remained buoyant in July with the unemployment rate remaining steady at 4.9%. The number of people claiming unemployment related benefits fell in July. Retail sales were strong in July. They were up 1.4% over June and were 5.4% higher year on year. As one would expect, inflation rose slightly in July as the pound depreciated. Whilst the month on month figure was -0.1%, the year on year level of inflation was 0.6%, up from 0.5% in June. So, the data is not telling us a lot at this stage and nor would one expect it to. Sterling based investors should consider the issues at the beginning of this review and make sure that they are positioned accordingly.

In conclusion, sterling based investors should regard the last quarter's returns as exceptional and related to a one off event, the EU referendum, which, by its nature will not be repeated if the UK government sticks with its stated aim of saying that "Brexit means Brexit". In so far that currency effects were influential in portfolios' performances over the last quarter, they do not represent a high quality reason for securities' price improvements. But our conclusion remains, in this time of very large market distortions caused by extreme monetary policy, that equities remain the most compelling of the asset classes available. However, we emphasise that progress is likely to be slower from now and that markets will experience periodic setbacks given the unsettled political and economic scene.

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