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ASSET MANAGEMENT (C.I.) LIMITED



## Investment Memorandum

International equity investors have experienced a satisfactory quarter, whilst bond investors have suffered a reverse, and commodities have risen for a number of different reasons. Currencies have shown sharp movements which have had a significant effect for investors, both for the quarter and for the year.

The tables below detail relevant movements in markets:

### International Equities 30.09.10 - 31.12.10

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+4.1	+10.9	+10.2	+12.2
Finland	+8.1	+6.9	+6.2	+8.1
France	+3.6	+2.4	+1.8	+3.6
Germany	+11.4	+10.2	+9.5	+11.4
Hong Kong, China	+1.9	+2.4	+1.8	+3.5
Italy	-1.1	-2.2	-2.8	-1.1
Japan	+8.8	+12.8	+12.1	+14.1
Netherlands	+5.5	+4.3	+3.6	+5.5
Spain	-5.9	-6.9	-7.5	-5.9
Switzerland	+2.7	+8.4	+7.7	+9.6
UK	+6.8	+6.8	+6.1	+7.9
USA	+10.8	+11.5	+10.8	+12.8
Europe ex UK	+4.4	+4.6	+4.0	+5.8
Asia Pacific ex Japan	+6.4	+10.8	+10.1	+12.0
Asia Pacific	+7.4	+11.7	+11.0	+13.0
Latin America	+5.0	+7.5	+6.8	+8.7
All World All Emerging	+5.6	+8.1	+7.4	+9.3
The World	+8.2	+9.7	+9.0	+10.9

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -2.1%



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

Currency	30.09.10	31.12.10
Sterling	2.95	3.40
US Dollar	2.52	3.29
Yen	0.94	1.12
Germany (Euro)	2.29	2.96

### Sterling's performance during the quarter ending 31.12.10 (%)

Currency	Quarter Ending 31.12.10
US Dollar	-0.9
Canadian Dollar	-4.2
Yen	-3.6
Euro	+1.0
Swiss Franc	-5.6
Australian dollar	-6.4

### Other currency movements during the quarter ending 31.12.10 (%)

Currency	Quarter Ending 31.12.10
US Dollar/Canadian Dollar	-3.4
US Dollar/Yen	-2.7
US Dollar/Euro	+1.9
Swiss Franc/Euro	+7.0
Euro/Yen	-4.5

### Significant Commodities (US dollar terms) 30.09.10 - 31.12.10 (%)

Significant Commodities	30.09.10 - 31.12.10
Oil	+15.1
Gold	+8.4



## PERFORMANCE DURING 2010

### International Equities 31.12.09 - 31.12.10

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+1.3	+19.1	+15.5	+23.5
Finland	+21.2	+16.9	+13.3	+21.2
France	+4.4	+0.7	-2.4	+4.4
Germany	+17.1	+12.9	+9.5	+17.1
Hong Kong, China	+19.1	+22.6	+18.8	+27.1
Italy	-9.0	-12.3	-15.0	-9.0
Japan	+0.5	+19.0	+15.4	+23.4
Netherlands	+6.0	+2.3	-0.9	+6.0
Spain	-14.5	-17.6	-20.1	-14.5
Switzerland	+2.2	+16.9	+13.4	+21.2
UK	+12.2	+12.2	+8.8	+16.3
USA	+15.1	+18.8	+15.1	+23.1
Europe ex UK	+5.5	+5.8	+2.5	+9.7
Asia Pacific ex Japan	+12.0	+24.4	+20.6	+29.0
Asia Pacific	+6.2	+21.9	+18.2	+13.0
Latin America	+10.0	+19.5	+15.9	+23.9
All World All Emerging	+14.4	+23.6	+19.8	+28.1
The World	+10.7	+16.3	+12.7	+20.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +7.2%

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

Currency	31.12.09	31.12.10
Sterling	4.01	3.40
US Dollar	3.84	3.29
Yen	1.29	1.12
Germany (Euro)	3.40	2.96



### **Sterling's performance during the year ending 31.12.10 (%)**

<b>Currency</b>	<b>31.12.10</b>
US Dollar	-3.4
Canadian Dollar	-8.2
Yen	-15.8
Euro	+3.5
Swiss Franc	-12.9
Australian Dollar	-15.3

### **Other currency movements during the year ending 31.12.10 (%)**

<b>Currency</b>	<b>31.12.10</b>
US Dollar/Canadian Dollar	-4.9
US Dollar/Yen	-12.8
US Dollar/Euro	+7.2
Swiss Franc/Euro	+18.8
Euro/Yen	-18.7

### **Significant Commodities (US dollar terms) 31.12.09 - 31.12.10 (%)**

<b>Significant Commodities</b>	<b>31.12.09 - 31.12.10</b>
Oil	+21.5
Gold	+29.5

### **Markets**

International equity markets have posted solid returns for the final quarter of 2010. The total return on the FTSE World Index in local currency terms was a creditable 8.2%, in sterling terms it was 9.7%, in US dollar terms it was 9.0% and in euro terms it was 10.9%. Looking firstly at the breakdown of the local currency returns, there was a notable performance from the FTSE USA index which returned 10.8%. Japan was also notable for an 8.8% return on the FTSE Japanese index, whilst there were good returns from the FTSE UK index (6.8%), the FTSE Europe ex UK index (+4.4%), the FTSE Australia index (4.1%), the FTSE Asia Pacific ex Japan index (+6.4%), the FTSE Latin America index (+5.0%) and the FTSE All World All Emerging Markets index (+5.6%). Interestingly, within the FTSE Europe ex UK index, there seems to have been a strong correlation between the relative financial strength of the particular eurozone economies and their stock market performance. Of the four largest eurozone economies, Germany returned 11.4%, France 3.6%, Italy -1.1% and Spain -5.9%, representing a ranking of financial strength with which most observers would agree.

Significant currency movements, notably the weakness of sterling and the euro during the quarter, significantly changed the position. For sterling investors, the strength of the yen meant that the FTSE Japanese index returned 12.8%. Japan is not a market which is always popular with foreign investors but, on occasions, it can provide high returns. With the US dollar strengthening against sterling, the sterling adjusted return on the FTSE USA index rose to 11.5%. Elsewhere, a very strong Australian dollar propelled the sterling return on the FTSE Australia index to 10.9% whilst returns on the FTSE Asia Pacific ex Japan index, FTSE Latin America index and FTSE All World All Emerging Markets index were raised to 10.8%, 7.5% and 8.1% respectively. A feature of the quarter was the strength of the Swiss Franc which raised the 2.7% return on the FTSE Switzerland index in local



currency terms to 8.9% in sterling terms. The Swiss Franc was so strong that, despite the weakness of the euro, the sterling return on the FTSE Europe ex UK index was actually a little higher than the local currency return at 4.6% against 4.4%.

As measured by ten year government benchmark bonds, there was a significant increase in yields over the quarter and these were for what, in the current environment, are considered relatively good credits. The gross redemption yield on the sterling government bond rose by 45 basis points to 3.40%, on US government bonds by 77 basis points to 3.29%, on Japanese government bonds by 18 basis points to 1.12% and on euro denominated German government bonds by 67 basis points to 2.96%.

As indicated above, there were some significant movements in the foreign exchange markets. Against the US dollar, sterling fell by 0.9%, against the Canadian dollar by 4.2%, against the yen by 3.6%, against the Swiss Franc by 5.6% and against the Australian dollar by 6.4%. Against a very weak euro, however, sterling rose by 1.0%.

In the commodity markets, oil and gold continued to rise, by 15.1% and 8.4% respectively.

If we look back at 2010 as a whole, we note a more than satisfactory return in local currency terms on the FTSE World Index at 10.7% which, in sterling terms increased to 16.3%, in US dollar terms to 12.7% and, in euro terms, to 20.6%. Looking at the local currency returns on the relevant indices, the USA provided an excellent return at 15.1%. The UK was good, too, at 12.2%. Europe ex UK was more subdued at 5.5%, whilst Japan hardly managed a positive return, just 0.5%. Asia Pacific ex Japan, Latin America and emerging markets returned strong performances at 12.0%, 10.1% and 14.4% respectively. As for the latest quarter's return, the performance of the stock markets of the four largest eurozone countries reflected their perceived relative financial strength. Germany returned 17.1%, France 4.4%, whilst Italy at -9.1% and Spain at -14.5% performed badly.

The effect of currency movements during the year made for currency adjusted return differences even more dramatic than for the last quarter. With sterling weak against all the major currencies except the euro, the sterling adjusted return on the FTSE USA index rose to 18.8%. For the FTSE Japanese index, the difference was enormous. A 0.5% local currency return rose to 19.0%, the best sterling return of the large markets. Another sterling return very significantly influenced by currency movements was the Australian market, where a 1.3% return in local currency terms on the FTSE Australian index rose to 19.1% in sterling returns. Within the Europe ex UK market, Switzerland likewise stood out. A 2.2% return on the FTSE Switzerland index became one of 16.9% in sterling terms. As with the quarterly return for the FTSE Europe ex UK index, the Swiss Franc's strength more than offset the euro's weakness to raise slightly the return on the FTSE Europe ex UK index from 5.5% in local currency terms to 5.8% in sterling terms. Elsewhere, currency movements against sterling greatly raised the sterling returns on the FTSE Asia Pacific ex Japan index from 12.0% in local currency terms to 24.4% in sterling terms, and the FTSE Latin America index from 10.0% to 19.5% and on the FTSE All World All Emerging Markets index from 14.4% to 23.6%.

Despite the poor last quarter for the benchmark ten year government bonds, detailed in our table at the beginning of this review, overall returns for the year on these high quality bonds were good. UK government bonds witnessed a 61 basis point fall in the gross redemption yield to 3.40%, US government bonds a 55 basis point fall to 3.29%, Japanese government bonds a 17 basis point decline to 1.12%, and euro denominated German government bonds a 44 basis point decline to 2.96%.

As for the last quarter, currency movements were dramatic, with the euro the weakest of the major currencies followed by sterling. Against the yen, sterling fell by 15.8%, by 15.3% against the Australian dollar, by 12.9% against the Swiss Franc, by 8.2% against the Canadian dollar and by 3.4% against the US dollar. Against the euro, however, sterling rose by 3.5%. The dramatic moves of the euro are shown by its 18.7% decline against the yen, whilst the Swiss Franc appreciated by 18.8% against the euro.

In the commodity markets, oil ended the year up by 21.5% and gold by 29.5%.



## Economics

As we look back over the past quarter and the calendar year as well, the performance of stock markets belies the still very serious economic conditions which apply in many countries. However, as we have often mentioned in our reviews, stock market and economic cycles do not have to be aligned so that apparent contradictions between the two are not necessarily an aberration.

We will come on to the economic and financial situation shortly, but we might try to rationalise the movements of markets in 2010. In the months leading up to March 2009, investors were gripped by fear of the unknown. Would the financial system collapse? Would bank deposits be safe? It is easy to be complacent now, nearly two years later, but the sense of panic was very palpable and justified in the sense that no one had experienced a blow up like this. Whilst we made a judgement that the authorities would do what was necessary to ensure the stability of the banking system, it was just that, a judgement, because none of us had known anything like it. Fortunately, the actions of the authorities around the world were successful. As it became clear that bank deposits would be safe, the sense of relief led to calmer market conditions and shares started to recover some of their falls. But it was just that, a relief rally from what we can now say were oversold conditions. There was a second and related issue which we felt would be helpful for asset values and that was the extreme and, in some cases, unorthodox monetary policy which was being followed by many countries. On the fiscal front, most countries were allowing budget deficits to balloon in order to provide an economic stimulus to offset the contractionary conditions arising from the financial crisis. That would be a conventional policy move, albeit that, in many countries, the starting point was not right. Fiscal laxity, in better times, had meant that many countries' public finances were in a bad way and, piling on extra debt, threatened trouble later on. But it was monetary policy action which caught the eye. Almost everywhere, interest rates were lowered to scarcely believable levels and, in countries like the USA and the UK, the central banks resorted to printing money under the guise of quantitative easing. Quantitative easing, in particular, was controversial, but its objectives were clear, some spelt out more explicitly than others. But, firstly, low interest rates were meant to relieve some of the cash flow pressure on borrowers and, through minimal interest rates, to encourage those with money to spend it. There were a lot of losers, of course. There are more savers than borrowers and many people depend on interest income to augment other sources of income. Quantitative easing, or the printing of money, was, besides providing banks with more money to lend, aimed at easing borrowing costs. The money was created by the central banks buying in bonds from the private sector and electronically crediting the seller with funds. The purchasing of bonds was meant to depress interest rates and, therefore, make it cheaper for businesses, in particular, to borrow money. A side effect, and one which was generally not spelt out by the authorities, was to boost asset prices and thereby create a positive wealth effect which might encourage economic activity. Newly created money available at low interest rates should increase the attractions of other assets like medium and longer dated bonds, equities and property. With next to nothing available on bank deposits, there has been a shift out of cash to other assets and bonds and equities have benefited. For bonds, the move has been indiscriminate in that it has clashed with fundamentals and we have indicated, in many of our recent reviews, that bond yields were too low and incompatible with the fundamentals. At a time of extreme crisis such as we saw from the autumn of 2008, money flooded into "safe" securities, such as government bonds and Treasury Bills, and that was understandable. After all, nothing should have been safer than government issued securities. Even if there was a negative real rate of return, it was better than having one's money in a failed bank. In these extreme circumstances, many equity dividend yields, prima facie, looked inviting, but investors had to have the confidence that they were sustainable. After all, if there was a major economic recession, or even a depression, those yields would not be safe. But, after the economic nadir of the first quarter of 2009, confidence that the doomsday scenario would not occur gradually helped to boost confidence in equities, and this catalyst to performance continued into 2010 helped by better economic news.



This last term is relative. The world economy is like the curate's egg, good in parts and in a very difficult situation in others. However, notwithstanding that the world economy showed an improvement in 2010, we should recognise that an improvement in asset values based upon very loose and unorthodox monetary policy, is not a high quality catalyst of asset values. Although it may not seem like it in the USA, the printing of money, unless the policy is reversed, threatens inflation later on. In the UK, where inflation is becoming a problem, the Bank of England's quandary is increasing given that it has constantly been over optimistic about inflation. So, a major word of caution about the quality of the rise in stock markets is in order. In the same way as investors became too pessimistic up to March 2009, so it is important to be realistic about what has led to an improvement in share prices in 2010 and not to get carried away. There has been a significant trend in mutual fund flows away from bonds, which have performed badly this last quarter, towards equities in recent weeks, reflecting concerns about bonds and following the stronger performance of equities.

Turning from the general to the particular, there is no doubt that, as the year progressed, the big story was the developing sovereign debt crisis in the eurozone. As with the financial crisis of 2008, the politicians and central bankers are having to develop policy as the crisis unfolds. Their problem is that they are dealing with a project, the euro, which is fundamentally flawed, something that no major politician or central banker involved in the eurozone dare yet admit. The eurozone sovereign debt problem is likely to be one of the key economic and financial issues for 2011 and how it plays out is likely to be an important stock market influence.

We are where we are with the eurozone sovereign debt issue, even though one would not have chosen to start from this position. The resolution of the sovereign debt issue is going to be very messy and the problem is going to continue for a long time. As we have seen from equity market movements in the eurozone this year, this problem may not necessarily impact negatively on equities. Some eurozone equity markets have done quite well, like Germany, but others have done badly, the pattern reflecting relative economic performance. Because all of the members of the eurozone have given up the right to pursue their own monetary policy, a number of them have been forced to accept interest rates which have been quite unsuitable for them, leading to the problems that are bedeviling countries like Ireland and Spain, where interest rates set far too low led to the property boom and, now, bust. Inflation rates, rather than converging, have diverged, and southern European members of the eurozone have lost competitiveness. The founders of monetary union did not contemplate a position where a member might default on its sovereign debt and all the contradictions of monetary union without fiscal union are now laid bare. Electorates were not consulted on the euro but, even for European governments which are euro members, it is a step too far to agree to a fiscal union and the German constitutional court would not allow it.

So what outcome should investors be prepared for? Two countries, Greece and Ireland, have already needed a bail out, albeit for different reasons, and there are fears about Portugal and, the big one, if it got into trouble, Spain. Greece was always profligate and it is difficult to imagine a country more different from Germany in the sense of countries which are compatible for a monetary union. The final straw occurred when its budget deficit figures were found to be seriously understated. For Ireland, which had been fiscally prudent, the problem was the vast size of its banking liabilities which swamped the economy. The property boom, funded by dangerously low interest rates (for Ireland), led to imprudent property lending which, now that property prices have collapsed, has led to huge bad debts. The guaranteeing of bank deposits by the Irish government brought into focus the solvency of the Irish state, hence the need for a bail out. The question is, where will problems strike next? Yields on 10 year government bonds, a good benchmark, tell us that Greece will have to restructure its debt and that bondholders, at some stage, expect a haircut, i.e. they will not receive back the face value of their bonds. At the end of 2010, the gold standard for eurozone sovereign credits, Germany, showed a gross redemption yield of 2.96% on its 10 year bond. The equivalent level for Greece is 12.55%, indicating the expectation of almost certain default. For Ireland, the level is 8.9%, indicating the same, if less, drastic outcome. With the policies imposed on these countries to get their fiscal deficit under control, it will probably be impossible to achieve the economic growth





necessary to service their debt, certainly not at these levels of interest rate. The equivalent yield on Portuguese bonds is 6.58%, indicating a strong belief that it will need help, for it cannot generate enough economic growth to service borrowings at this level of interest rate. Next in line is the one which would really be traumatic if it hit problems, Spain. There the 10 year government bond yield, at present 5.34%, is again indicating extreme investor nervousness. Further down the line, we have Italy, where the yield is currently 4.71%. Even AAA rated France's bonds have a noticeable yield premium over Germany's bonds, 38 basis points at present. Investors and politicians were guilty of the belief that a euro was a euro whatever country was behind it. Sovereign risk was not considered. Looking back at the yield on 10 year government bonds on the last trading day of 2006 before any of this blew up, we see that Greek government bonds were trading on a premium of 27 basis points to those of Germany (now 954 basis points), whilst Spain's 10 year bonds traded on a yield of just 4 basis points higher than those of Germany, effectively treating Spain as an equivalent credit to Germany. Now the difference is 238 basis points.

If a monetary union is to be credible, economies have to converge to make them closely resemble one another economically. This has clearly not happened. Inflation and relative unit labour costs have diverged in a number of countries against the benchmark, Germany. The budget deficit rules of the Stability and Growth Pact were flouted even by the big players and, as things stand now, serious doubts are now being aired by some about whether the eurozone can continue in its current form. A year ago, except amongst those who thought the idea was flawed from the start, it was considered a heresy even to mention a break up of the eurozone. Now that is not so. Even if eurozone politicians and members of the ECB feel this way, they dare not mention the subject for fear of damaging confidence even further. The subject is very delicate.

But investors need to consider the possible outcomes of the sovereign debt crisis in the eurozone in order to tailor their strategy to the situation. One issue to consider is the outcome if problem countries stay in the eurozone or leave. If they stay in, they have to regain their competitiveness. They are denied the normal policy tool of devaluation if they stay in so they have to deflate their way to restoring competitiveness with the best of their peers. The pain which this will inflict may be unacceptable in some countries. Greece is experiencing regular industrial action and the unpopularity of the government which, under outside pressure, has been forced to impose these policies, could lead to another government being formed which promises a gentler path to normality. This would, of course, lead to another crisis, with departure from the eurozone more likely. In the first instance, dramatic fiscal tightening and no devaluation would make domestic companies unattractive in these economies. Companies with significant overseas exposure, particularly where it is to fast growing economies, could expect to see their share prices perform better. What if the pain was too much for some of these countries and, despite all the problems which it would cause, they decided to leave the eurozone? The new currency, perhaps the former legacy one, would be devalued against the euro and this would normally be expected to give a boost to the economy as exports benefited and import substitution took place. There would be plenty of bad effects, too, for those companies with euro denominated debt, but devaluation will reduce the negative effects of the straitjacket of monetary union. Devaluation may be expected to give a boost to shares in such economies, although with qualifications such as the euro denominated debt issue mentioned above which would be more difficult to service and increase substantially the chance of default.

In case the above suggests the possibility of a eurozone member leaving the single currency is a relatively easy procedure, it is important to say here that it is not. Such a situation, like a sovereign debt default, is not something which was ever contemplated and there is no mechanism available. Therefore, it would be an extremely messy and complicated process with massive problems. The alternative, remaining in, might be even worse because there would seem to be no light at the end of the tunnel, just the prospect of a long period of fiscal tightening and a fall in real incomes combined with a number of years of economic contraction or, at the very best, very slow growth.

The elephant in the room is, of course, bank exposure to the troubled economies of the eurozone whether it be sovereign debt, corporate debt or interbank funding. The Bank for International Settlements produced figures as



at 30 June 2010 giving the broad exposure of banks to various European countries, although it was not broken down by type of exposure as it included all of the above types of lending. As a broad indication, however, exposure to Greece by banks located in France, Germany, Ireland, Italy, Portugal, Spain and the UK amounted to above US\$126 billion. Exposure to Ireland, excluding Irish banks, was given as about US\$386 billion. Exposure to Portugal, excluding Portuguese banks, was about €189 billion, whilst exposure to Spain, the big one in this group, excluding Spanish banks, was about €529 billion. Even though the figures are not disaggregated by type of lending, the figures are obviously very big, so they are a major issue for policy makers and investors.

To try to stabilise the sovereign debt concerns in the eurozone, a potential €750 billion war chest was assembled by euro members. The package comprised the European Financial Stability Facility which has the capacity to issue bonds guaranteed by Euro Area Member States for up to €440 billion which, subject to strict conditions, is available to lend to eurozone states in trouble and unable to finance their borrowings at acceptable rates. A further €60 billion would be available from the European Financial Stabilisation Mechanism (these are funds raised by the European Commission and guaranteed by the EU budget). A further €250 billion would be available from the IMF. So far, a €110 billion loan to Greece and up to €85 billion (some from non eurozone members, the UK, Sweden and Denmark, as well as €17.5 billion from Ireland through its National Pensions Reserve Fund) for Ireland have been agreed. It can be seen that the eurozone would face even more serious problems if really big economies like Spain got into trouble with these sort of risks increasing. The ECB announced, in December, that it was ready to double its subscribed capital by asking for a further €5 billion to take it from €5.76 billion to €10.76 billion.

There is significant concern in relatively strong eurozone countries such as Germany that its involvement in supporting financially troubled eurozone countries will weaken its own creditworthiness. Germany's guarantee commitment for the European Financial Stability Facility is just over 27% of the potential total of €440 billion, nearly €120 billion. If it was called upon to exercise any of the guarantee, it would weaken Germany's finances. So these arrangements cannot grow without limit without transmitting contagion throughout the eurozone. There is significant opposition within Germany to extending support to eurozone countries in trouble.

The eurozone, therefore, from a stock market point of view has the potential to cause a lot of problems for investors in 2011. A lot of maturing debt has to be refinanced which will test investors' appetite for risk in the eurozone countries where current government bond yields indicate concern. Whilst the yield on Portuguese government bonds indicate a strong possibility of eurozone financial support, the litmus test will be Spain, where net medium and long term debt issuance will be €47.2 billion in 2011. The European banks are obviously highly vulnerable to sovereign or corporate debt problems in the eurozone and we saw in 2008 and early 2009 what effect concerns about the banking system could have on the stock markets.

Whilst attention is focused on the eurozone, investors should not forget the debt problems of the USA, which are extremely serious but which are not, as yet, an investment issue. At some stage, possibly in 2011, the very serious state of the USA's public finances will become an investment issue. At present, investors seem to concentrate on one risk at a time and this, quite naturally, is the eurozone. As the world's largest reserve currency, the US dollar has an advantage over other currencies as it has to be a major component of many countries' foreign exchange reserves. Therefore, countries have to respect it or risk significant losses of foreign exchange reserves. But they cannot respect it for ever if the country refuses to acknowledge the issue. With a budget deficit of around 10% of GDP, exacerbated by the recent deal between Congress and the President on the budget, there is a serious risk of currency debasement. The US political system militates against quick decisions. The systems of checks and balances delays decision making between the executive and the legislature. This is the danger in the USA. The lack of urgency about tackling the US deficit will be a stock market issue at some stage. The trend is unsustainable.

Rapid economic growth in Asia has been very helpful in supporting the world economy. A potential concern is Chinese inflation. China has been tightening monetary policy for a while as inflation, led by food prices, has



started to rise quickly. The latest year on year rate of inflation stands at 5.1%, but the rate for food price inflation is 11.7%. Markets are very nervous of measures by China to slow down its economy because of the effect elsewhere. In 2011, we can expect the Chinese authorities to remain very vigilant about inflation and actions to tighten policy could adversely affect market sentiment.

This time last year, investors in the UK were contemplating the forthcoming General Election and were concerned about the possibility of an indecisive result. A formal coalition between the Conservatives and Liberal Democrats would not have been the expected outcome. The agreed coalition programme of an elimination of the structural deficit over the lifetime of the current parliament, assuming it lasts the course, has been well received by markets as the most resolute programme of action of any country to tackle the crisis in public finances. The test will come as the measures start to take effect. The trade unions are threatening serious action to try to defeat the measures and the student protests may be a sign of things to come. A coalition has natural tensions and, if it were to show signs of weakness on eliminating the deficit, and there is no reason to believe at this stage that it will, the effect on markets would be strongly adverse. The very serious state of the UK's public finances threatened the UK's AAA rating and sterling before the General Election. Decisive action to eliminate the deficit has meant that the UK's borrowing costs are broadly comparable with those of the USA and not vastly above those of Germany. It could have been very different if the UK had remained in denial about its public finances as it was until election time. It is going to be a very difficult year for the UK, with significant industrial unrest very likely and, accordingly, it will be a testing year for the coalition. Depending on how matters develop, this, too, could be a market factor, for, with public finances in such a dreadful state, backsliding is not an option. Although this is intuitive, objective evidence can be seen from the extent to which the weaker eurozone members have been punished for the poor state of their public finances and sometimes reluctant moves to make decisive measures to rectify their finances. As well as spending cuts and tax rises, the necessary supply side changes, for instance reforming labour markets to make it easier for companies to employ people, have mostly been lacking. The UK retains the invaluable advantage of having its own currency, and sterling's weakness in recent times has given it a competitive advantage, but a negative reassessment of the UK's creditworthiness in the event of slippage in its programme of deficit elimination could be badly received. This is another potentially negative factor for 2011.

If, in looking at the events which could influence the stock markets in 2011, we seem to have emphasised the negative angle, it is to emphasise that the improvement in asset prices in 2010 has been against an economic background which is still very dangerous. It is important that a background of positive returns for 2010 does not lead to investor complacency.

Notwithstanding this strong caveat, there are reasons to remain positive for shares, although not for bonds, in 2011. Providing China does not slam on the economic brakes, economic growth in China, India, other parts of Asia and the Middle East, as well as Brazil and some other countries, should contribute to a satisfactory overall outcome for world economic growth. To put the economic influence of emerging and developing economies into perspective, the IMF, in its October 2010 World Economic Outlook, estimated that on a purchasing power parity basis, which is an estimate of what currencies should stand at against each other based on each currency's purchasing power, emerging and developing economies represented 46.2% of world GDP. In that same review, the IMF forecast world economic growth at 4.2% in 2011 compared with its estimate of 4.8% for 2010. Within that overall figure for 2011, emerging and developing economies were forecast to grow at 6.4% compared to 2.2% for advanced economies. Taking a country based approach, the OECD forecasts economic growth in China of 9.7% in both 2011 and 2012, compared with 10.5% in 2010, whilst, for India, its forecasts are for growth of 8.2% in 2011 and 8.5% in 2012 compared with its expectation of 9.1% for 2010. On the other hand, for the 34 OECD countries (which do not include countries like China, India or Brazil) the expectation is for economic growth of 2.3% in 2011 and 2.8% in 2012 compared with 2.8% in 2010. These are not dramatic figures but, given the background, they are acceptable. They do, however, show how important it is for the world economy



that, whilst many western countries are having to put their fiscal house in order and, by doing so, depress economic activity, emerging and developing countries, many of which have much sounder domestic finances, are providing some offsetting stimulus. Encouragingly, the outlook for corporate profits looks satisfactory. When the financial crisis took hold, many companies took immediate steps to batten down the hatches and cut costs. Now that business has improved, corporate profits are rising and are expected to continue doing so in 2011. Current forecasts point that way and dividends are expected to follow. This will be important for international equity markets because of the recent rise in bond yields which will provide more competition for equities. The extraordinarily low bond yields, which have been evident as a result of a flight to quality and quantitative easing, where it has taken place, gave rise to a situation where equity yields often exceeded bond yields. That indicated a pretty pessimistic scenario. On current year estimates, for example, the dividend yield on the Euro Stoxx 50 Index is estimated at almost 4.5%. The index comprises large blue chip stocks based in the eurozone. That yield far exceeds the ten year government bond yields of Belgium, Finland, France, Germany and the Netherlands, although not, of course, weaker credits like those of Spain and Italy, not to mention the most seriously compromised eurozone economies. At a time when there are serious concerns about the solvency of some eurozone countries, the solid return provided by yields like this is attractive for investors. For many of these large blue chips derive substantial earnings from overseas countries with much better growth prospects than the eurozone. The situation is even more extreme in Switzerland where this year's estimated dividend yield of about 3.2% compared with the ten year Swiss bond yield of 1.74%. Because of the problems of the eurozone, money has flooded into Switzerland. Japan, often a market unloved by investors, shows an estimated dividend yield on the Nikkei 225 of nearly 1.8% compared with a 1.12% yield on the ten year JGB. In the UK, as elsewhere, the rise in the stock market and the sharp rise in bond yields has changed the relative position in that, if we take the FTSE 100 index, the estimated dividend yield for the current year, at about 3.15%, is below that of the ten year gilt, which stands at 3.45%, with the yields having recently crossed over. Nevertheless, the relationship is still favourable to equities with further significant growth expected for next year. In the USA, the rise in US Treasury bond yields has left the comparison less favourable with an expected yield on the S & P 500 Index for this year at about 1.8% compared with a 3.35% yield on the ten year Treasury bond.

Tangential to this is the unusual situation we had in 2010 where shares, bonds and gold all rose in value. Admittedly, bonds suffered a bad financial quarter but, for the year as a whole, taking high quality benchmark government bonds, the return was positive as our table for the year shows. But it cannot be right that all provided positive returns. The rise in gold suggests investors fear renewed inflation and have a lack of confidence in paper currencies. The low level of high quality government bond yields suggests investors are not concerned about inflation or are so worried about the economic outlook that they are prepared to accept such unattractive returns. If the latter were the case, one would not have expected equity prices to rise. Some class of investor is going to be disappointed and we continue to believe that it is bond investors. The level of economic growth suggested by the IMF and OECD surveys, which is based on the evidence which they had available at the time, does not tie in with a deflationary outlook and the current concern about oil and food prices, not to mention other commodities, suggests that widespread deflation is very unlikely. Whilst very low interest rates and selective quantitative easing continue to exist, one can see why gold investors remain interested in the metal. Other things being equal, equities should be a good hedge against moderate, but not excessive, inflation, as companies with sufficient pricing power raise prices. This should enable dividends to rise. A substantial acceleration in inflation, however, would be bad for equities and bonds as central banks would need to raise interest rates sharply. Because short term interest rates are so abnormally low there is plenty of scope for them to rise towards more normal levels which, in the UK, within inflation at well over 3% one would normally expect to see at 5% plus. Interest rate rises beyond that would start to undermine the attraction of shares. Whilst fiscal policy is so tight, a very loose monetary policy can be an offset, but there is only so far that central banks can go in ignoring the threat posed by inflation.



If we now turn to look at individual countries and areas of the world, the economic news is, naturally, mixed but this is a significant improvement from 2009 when nearly all the news was bad. As we have indicated, there are many problems for the world economy, and specific problems for individual countries and regions, but the economic outlook for 2011 is one of overall economic growth, even though, as we have stated earlier, it is patchy.

In the USA, the housing market is likely to remain a problem, with only a small number of items of good news. According to the S & P/Case Schiller index for September, house prices fell by 0.8% compared with the previous month. According to that index, home prices have fallen by 28.6% since the peak in June 2006. The National Association of Home Builder's index remained unchanged at 16 in December, a figure which signals that most house builders see the housing market conditions as poor. Sales of new homes in November were lower than expected at 290,000, and the previous month's figure was revised downwards to 275,000. Existing home sales rose 5.6% in November, although that was 28% below the figure for a year before. There was a small increase in house prices of 0.7% in October but, over the last twelve months, the Federal Housing Finance Agency reported a 3.4% drop in prices. The National Association of Realtors pending home sales index showed that contracts for pending sales of previously owned US homes rose by 3.5% in November compared with October. So the news on housing is mixed, but it is unlikely to be a strong year, and falling house prices and foreclosures provide a negative wealth effect which is not good for consumer confidence. In the jobs market, US non-farm employers hired an additional 103,000 employees in December, but this is not enough to bring down the unemployment rate sharply, which stands just below 10%. Although firms are in a much better position financially than they were during the financial and economic crisis, they are being very cautious about taking on new staff. Additionally, the serious financial position of many states and local authorities in the USA is going to mean a fall in employment in the public sector. A number of items of individual news were positive for the USA and, as we enter 2011, the economy does appear to have some momentum. The ISM services index for December rose to 57.1 from 55 in November. This represents the fastest pace of increase for over four years. Consumer sentiment is strong. The Thomson Reuters/University of Michigan index rose to 74.2 in December compared with 71.6 in November. Retail sales have been quite strong, rising by 0.8% in November, with the estimate for October increased to a 1.7% gain. Industrial output rose in the USA in November by 0.4%. This came after a 0.2% fall in October. The year on year increase in industrial output is 5.4%. The Empire State index of manufacturing activity in New York rose by 10.6 in November, following a negative figure in October, which is now regarded as an aberration. Household spending in the USA rose by 0.4% in November, which is the fifth consecutive monthly rise. Orders for US durable goods fell by 1.3% in November. However, excluding erratic transport figures, orders rose by 2.4%. The Chicago Purchasing Managers index rose to 68.6 in December compared with 62.5 in November. The key event, which we have touched upon earlier, which has helped sentiment, has been the tax deal between President Obama and Congress. A US\$120 billion payroll tax holiday and an extension of all the Bush era tax cuts have caused economists to raise their forecast for economic growth in 2011, perhaps to somewhere around 3%. However, as we mentioned earlier, this stimulus comes at a price with a budget deficit at around 10% of GDP, representing a very dangerous situation which has to be addressed.

We have touched upon the general problems of the eurozone and they transcend everything else in importance. However, the one glimmer of light is the strong performance of the German economy which has remained competitive during the first years of the euro and has a manufacturing profile which is well suited to service the faster growing areas of the world. Extreme optimists hope that the strong performance of the German economy will encourage German consumers to spend more and, by extension, therefore help the struggling eurozone economies. But, a major problem for many of these economies is that they do not produce the goods that are in significant demand in China, Asia and other fast growing markets, whereas Germany is ideally placed. If we look at some indicators from Germany, we note that the purchasing managers index for Germany's services sector accelerated in November at its fastest pace for three years, with the index rising to 59.2 compared with 56.0 the previous month. Industrial orders rose by 1.6% in October in Germany. Industrial production in October rose by 2.9% after falling 1.0% in September. An economic confidence survey by ZEW showed a rise of 1.1 to 82.6





in December. In Japan, although modest growth is expected this year, the IMF expects a rate of growth of 1.5% in 2011 compared with 2.8% in 2010. The main issue is the very serious level of public debt as a percentage of GDP. It is not a problem at the moment because the vast majority of debt is financed internally, but it is not a situation which is sustainable, and will have to be addressed. But Japan has not been very good at addressing these problems. Probably the obvious answer is to raise the consumption tax but this is politically difficult. This issue is likely to be one of the key considerations for 2011 in Japan.

The main issue in China is one which we have discussed earlier, namely concern about inflation. China needs to grow rapidly in order to absorb people coming onto the employment market and to avoid social unrest but rapidly rising food prices could easily cause discontent. Hence, the main issue will be how the authorities deal with the problem. They have started to raise interest rates and to require banks to keep higher reserves to dampen down the economy generally, but food price increases can be driven by other issues. As we have noted before, actions in China can affect markets, at least temporarily, elsewhere. What investors dread is very strong measures by China to try to clamp down on inflation because of the perceived affect on China's demand for imports, which have helped many other countries to avoid the worst of the recession.

In the UK, the manufacturing sector has been performing very well although, these days, it is a very small percentage of the UK economy, so its effect on the wider economy is limited. Encouragingly, also, there has been a strong recovery in business investment which rose by 3.1% during the third quarter to show an 8.9% increase year on year. As indicated earlier, the UK is in a very delicate position. Action to eliminate the deficit over the life of the parliament is essential, to avoid a loss of confidence in the UK which, as we have seen with some of the weaker eurozone countries, can mean that economic management is effectively taken out of their hands. The restraint on public expenditure and tax increases, together with wage restraint, either caused by market conditions or government action in the public sector, are going to mean a fall in real incomes. So, it is easy to construct a case to say that the UK will face a very difficult year and, of course, that is what it will be. Those who argue for a gentler approach to reducing the budget deficit, cite this as an argument for their case. However, what they do not consider is the market reaction and, whether investors like it or not, confidence is a key ingredient of economic success or otherwise. So there is a risk but, on the other hand, confidence in the economy and amongst businesses might well rise as they see the public sector starting to shrink, relative to the economy, and thereby avoid crowding out the private sector. It is a fine line. Most independent commentators expect that the UK will pull through and take the optimistic view, although opinions are heavily qualified. Our investment strategy largely concentrates on large capitalisation blue chips in the UK sector of our portfolios, with significant overseas exposure as a way of mitigating the risks.

We remain in a very unnatural economic position and investors have to think on their feet as events unfold. We have detailed what we believe, at this stage, will be the major issues of 2010 and they have the potential to destabilise markets temporarily just as has occurred from time to time in 2010. But we expect equities to be the best performing of the major asset classes with bonds the worst. We think, however, that progress will be uneven given how many serious economic issues abound. For those predominantly in cash, those setbacks should provide an opportunity.

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