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ASSET MANAGEMENT (C.I.) LIMITED



## Investment Memorandum

With the exception of the US market, international equities have drifted upwards during the quarter to leave the year showing satisfactory returns. There has been no significant movement in top quality sovereign bond yields as measured by ten year government bond yields but, in the currency markets, the feature has been the weakness of the yen during the quarter. Gold fell during the quarter but was higher over the year.

The tables below detail relevant movements in markets:

### International Equities 28.09.12 - 31.12.12

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+7.1	+6.3	+7.0	+4.4
Finland	+9.8	+11.8	+12.5	+9.8
France	+8.5	+10.4	+11.1	+8.5
Germany	+5.7	+7.6	+8.3	+5.7
Hong Kong, China	+7.0	+6.3	+7.0	+4.4
Italy	+6.8	+8.7	+9.4	+6.8
Japan	+17.6	+5.1	+5.8	+3.2
Netherlands	+7.2	+9.1	+9.8	+7.2
Spain	+7.8	+9.7	+10.4	+7.8
Switzerland	+5.2	+7.3	+8.0	+5.4
UK	+3.7	+3.7	+4.3	+1.8
USA	-0.2	-0.9	-0.2	-2.6
Europe ex UK	+6.3	+8.1	+8.8	+6.2
Asia Pacific ex Japan	+4.5	+4.7	+5.4	+2.9
Asia Pacific	+9.5	+4.9	+5.6	+3.0
Latin America	+5.1	+3.6	+4.3	+1.8
All World All Emerging	+6.5	+5.1	+5.8	+3.2
The World	+3.3	+2.3	+3.0	+0.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -0.4%

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

Currency	28.09.02	31.12.12
Sterling	1.71	1.85
US Dollar	1.61	1.76
Yen	0.77	0.79
Germany (Euro)	1.44	1.32



### **Sterling's performance during the quarter ending 31.12.12 (%)**

<b>Currency</b>	<b>Quarter Ending 31.12.12</b>
US Dollar	+0.6
Canadian Dollar	+1.7
Yen	+11.8
Euro	-1.9
Swiss Franc	-2.0
Australian dollar	+0.6

### **Other currency movements during the quarter ending 31.12.12 (%)**

<b>Currency</b>	<b>Quarter Ending 31.12.12</b>
US Dollar/Canadian Dollar	+1.1
US Dollar/Yen	+11.2
US Dollar/Euro	-2.4
Swiss Franc/Euro	+0.1
Euro/Yen	+13.9

### **Significant Commodities (US dollar terms) 28.09.12 - 31.12.12 (%)**

<b>Currency</b>	<b>Quarter Ending 31.12.12</b>
Oil	-1.1
Gold	-6.9



## Performance During 2012

### International Equities 30.12.11 - 31.12.12

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+20.1	+16.2	+21.6	+19.7
Finland	+13.1	+9.9	+14.9	+13.1
France	+21.8	+18.2	+23.7	+21.8
Germany	+29.4	+25.6	+31.4	+29.4
Hong Kong, China	+28.7	+23.3	+29.0	+27.0
Italy	+12.1	+8.9	+13.9	+12.1
Japan	+21.5	+3.3	+8.1	+6.4
Netherlands	+17.0	+13.6	+18.8	+17.0
Spain	+3.7	+0.7	+5.4	+3.7
Switzerland	+18.9	+16.1	+21.5	+19.6
UK	+10.6	+10.6	+15.7	+13.9
USA	+16.3	+11.2	+16.3	+14.5
Europe ex UK	+20.5	+17.8	+23.2	+21.3
Asia Pacific ex Japan	+19.1	+17.7	+23.1	+21.2
Asia Pacific	+20.0	+11.5	+16.6	+14.8
Latin America	+12.4	+4.0	+8.8	+7.1
All World All Emerging	+18.8	+12.8	+17.9	+16.1
The World	+16.7	+11.8	+17.0	+15.2

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +2.7%

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

Currency	30.12.11	31.12.12
Sterling	1.98	1.85
US Dollar	1.88	1.76
Yen	0.98	0.79
Germany (Euro)	1.83	1.32



### **Sterling's performance during the year ending 31.12.12 (%)**

<b>Currency</b>	<b>Year Ending 31.12.12</b>
US Dollar	+4.7
Canadian Dollar	+2.5
Yen	+17.8
Euro	+2.8
Swiss Franc	+2.0
Australian dollar	+3.4

### **Other currency movements during the year ending 31.12.12 (%)**

<b>Currency</b>	<b>Year Ending 31.12.12</b>
US Dollar/Canadian Dollar	-2.1
US Dollar/Yen	+12.5
US Dollar/Euro	-1.8
Swiss Franc/Euro	+0.8
Euro/Yen	+14.6

### **Significant Commodities (US dollar terms) 30.12.11 - 31.12.11 (%)**

<b>Currency</b>	<b>Year Ending 31.12.12</b>
Oil	+3.5
Gold	+7.1

### **Markets**

Equity markets have shown a modest rise during the quarter. In total return terms, the FTSE World Index has returned 3.3% in local currencies, 2.3% in sterling, 3.0% in US dollars and 0.5% in euros. In local currency terms, the outstanding performer has been Japan with the FTSE Japanese Index returning 17.6% whilst, at the other end of the spectrum, the FTSE USA Index showed a negative return of 0.2%. However, currency movements were significant and the weakness of the yen, the catalyst for the good local equity market performance in Japan, reduced the sterling return to a still respectable 5.1%. Weakness in the US dollar caused the sterling return on the FTSE USA Index to worsen to -0.9%. The FTSE Europe ex UK Index performed strongly in local currency and sterling terms with returns of 6.3% and 8.1% respectively. Australia, too, performed well with local currency and sterling returns on the FTSE Australia Index of 7.1% and 6.3% respectively.

In the high quality sovereign bond market, as measured by ten year government bonds, yields tended to drift higher, 14 basis points in the case of the UK government bond to 1.85%, 15 basis points to 1.76% for the US Treasury bond and 2 basis points to 0.79% for the Japanese government bond. On the other hand, the German Bund showed a fall in yield of 12 basis points to 1.32%.

The feature of the currency markets, driven by political factors, was the weakness of the yen against which sterling rose by 11.8%. The euro and Swiss Franc were the strongest currencies. Sterling fell 1.9% against the euro and by 2.0% against the Swiss Franc.



In commodity markets, oil was slightly lower over the quarter with Brent crude declining by 1.1% and gold declining by 6.9%. Interestingly, iron ore prices recovered sharply off their low point in the quarter, perhaps giving a pointer to what is happening in China.

For 2012, as a whole, the FTSE World Index showed a useful recovery. As measured by the FTSE World Index, the local currency total return was 16.7%, the sterling return 11.8%, the US dollar return 17.0% and the euro return 15.2%. In local currency terms, there were above average returns from Europe ex UK, +20.5%, Australia, +20.1%, Asia Pacific ex Japan, +19.1% and emerging markets, +18.8%. Japan returned +21.5% after a strong fourth quarter. The UK, +10.6%, USA, +14.2% and Latin America, +12.4%, were laggards although, in absolute terms, those returns were very good. In sterling terms, the weakness of the yen reduced the return on the FTSE Japanese Index to just 3.3%. With sterling moving higher over the year, foreign currency returns were lower than local currency returns for sterling investors, but there were still exceptionally good returns in Australia (+16.2%), Europe ex UK (+17.8%), and Asia Pacific ex Japan (+17.7%). Because of currency weakness, the return in sterling terms on the FTSE Latin American Index was +4.0%.

In the currency markets, sterling was stronger all round, rising 4.7% against the US dollar, 2.5% against the Canadian dollar, 17.8% against the yen, 2.8% against the euro, 2.0% against the Swiss Franc and 3.4% against the Australian dollar.

Oil, as measured by Brent crude, was up 3.5% and gold by 7.1%.

## **Economics**

In many respects the year has ended as it began with the main issues being unresolved and not much encouragement to be gained from developments within those main problem areas. Nevertheless, stock markets have risen and, counter intuitive as this may seem, it is logical for the reasons given many times in these reviews. However, the world remains a very dangerous place economically, as well as politically (we think of Iran and the Japan/China stand off over the disputed islands) and, whilst our message to our clients is exactly the same as a year ago in terms of the relative attractions of equities, we do not believe it will be a smooth ride with setbacks occurring from time to time within an upward trend for equities which will give opportunities to commit further cash to the market. Whilst equities have performed much as we expected, high quality bonds have performed better than we expected for various reasons but this does not alter the fact that they are very overvalued and carry the risk of a severe price correction. The gross redemption yields on the high quality sovereign bonds shown at the beginning of this review remain significantly out of touch with reality and, in our view, it is only a question of time before fundamentals reassert themselves.

In our view, the three main economic issues for investors to consider are the eurozone, the potential “fiscal cliff” in the USA and China. Below those, but still very important, are developments in Japan (a new government) and the still very serious state of the UK’s public finances, although the UK is not, of course, alone in this matter.

Dealing first with the eurozone, the paradox is that the FTSE Europe ex UK Index has performed very well in 2012 although this reverses a dismal performance in 2011. It is as if investors have become bored with the continuing woes of the eurozone and have moved on to other issues. We have often remarked in these reviews that it is important to separate the woes of a particular country or, in the case of the eurozone, a currency bloc, from its stock markets. The financial position of many companies is far superior to that of their sovereign and can be distinguished from it in terms of investment decisions. What really gave impetus to the rally in eurozone stocks were the remarks of Mr Mario Draghi, the President of the European Central Bank, in the summer, that, to paraphrase, he would do whatever it takes to save the euro. This was a masterful display of shaping expectations even though the big policy announcement of Outright Monetary Transactions (OMT) has yet to be implemented. It does depend on a government asking for financial assistance and, in effect, handing over economic policy to the



eurozone's authorities. So far, no country has asked so it has not taken effect. But the effect on the bond yields of troubled eurozone countries has been significant. The ECB's aim is to give confidence that the eurozone will not break up, thereby encouraging investors to buy and hold euros. However, markets can only respond for so long to words rather than actions and the eurozone has a history of big promises which have come to nothing. OMT, if it happens, may improve the transmission effects for a time but it will only act on the symptoms of the eurozone crisis, not its causes, and, in this respect, we are no further on than this time last year.

The problem, as many recognise, is that the eurozone is not an optimal currency area in the sense that members of the eurozone do not display enough economic and financial similarities to make the adoption of a single currency a good idea. Because the euro was, and still is, a political project every effort was made to accommodate countries for political reasons even when the economics was not right. This crisis started when the then new Greek PASOK government revealed that the published levels of government borrowing had been wildly inaccurate. This opened up a can of economic worms in the eurozone resulting in a crisis which we now see. It is worth trying to sum up the issues, which are complex, even at the risk of oversimplifying the problem. Complacency set in with the adoption of the single currency and its subsequent enlargement (including Greece). Many participants felt that a euro was a euro, whichever government was behind it. Hence, in the government bond market, we saw for a time, as was meant to happen, that sovereign bond yields converged. At one time, there was very little difference in the gross redemption yields on German and Greek bonds. In other words, investors saw Greek bonds as only carrying a slightly higher degree of risk than German ones, an expensive mistake for private investors who have experienced very severe losses on their "haircuts". Bond yields were supposed to converge in line with the underlying economies. Such thinking was completely fanciful. Germany and Greece have hardly anything in common. One of the important convergences should have been inflation and relative costs but the troubled countries allowed the latter to rise against the more disciplined eurozone economies and, as a result, their current account position deteriorated. If investors are willing to finance these deficits, well and good for the short term but, as we now see, a monetary union cannot hide weaknesses within it. In countries like Spain and Ireland, when ECB interest rates were too low and showed the fundamental flaw of a "one size fits all" interest rate, property booms developed because of cheap and plentiful money. The financial crisis put paid to that boom resulting in desperate problems for many of the banks in those countries. These countries, and others, became cut off from financial markets, hence the position in which the eurozone now finds itself. Crucially, the normal safety valve for these uncompetitive countries would have been devaluation and internal adjustments to counteract the inflationary effect of such a policy demanded by creditors such as the IMF. Because so much political will has been invested in the euro project and because many of those directly and indirectly involved with the project are still in positions of authority, the sense of denial has only strengthened. It would be very embarrassing to admit that the euro was a mistake and they are digging deeper and deeper into the hole. The current policies being dictated to the bail out countries, Ireland, Greece and Portugal, as well as elsewhere in the eurozone, in terms of dictating deficit reduction policies, are likely to bring severe social unrest, evidence of which we already see. If we look at those three countries, and take into account Spain as well, policies of internal devaluation are being imposed upon them in the absence of the ability to devalue their currency. So there are wage and pension cuts, government spending cuts and tax rises but, in trying to cut their deficit and become more competitive, austerity upon austerity is being heaped upon them and one wonders where economic growth, the best solution to their problems, will come from. If one looks at Spain, the fourth largest eurozone economy, youth unemployment is over 50%. It is likely that social unrest in one or more eurozone countries will topple their governments and bring into power governments which repudiate the economic medicine being visited upon them. Countries might well leave the euro in such circumstances because their electorates will not take it. We see also problems with the creditor countries. We often hear the expression "more Europe" as an answer to the eurozone's problems, here meaning a move towards fiscal union. Germany, as the most powerful eurozone country, is driving the programme but the German electorate is sceptical about the financial commitments Germany, and others, are



taking on and Mrs Merkel has to move slowly as she faces elections later in 2013. Although it is the private sector which has taken the “haircut” on Greek debt so far, everyone knows that the official sector is going to have to written off some of the Greek debt but it is not a subject which is allowed to be mentioned officially in front of the German election. So the eurozone staggers from crisis to crisis, always trying to deal with the symptoms but never the cause of its problems which is that it is not a viable monetary union. One of the big issues we think for 2013 is how France reacts to the austerity measures it has to take to redress its serious economic problems, not only its deficit position but also its major loss of competitiveness, notably against Germany. In a sense, it has done the easy bit, raising taxes on the wealthy and big business, but hard decisions on public spending cannot be put off much longer. The public sector accounts for about 56% of French GDP, not a sustainable position if growth has to accelerate, which it does. Before the 2012 elections neither of the main French political parties really discussed the seriousness of France’s public debt position nor its loss of competitiveness. With the new government’s and president’s popularity having fallen since the election, the outcome of the necessarily tough economic decisions which have to be made in France could be a big issue for markets in 2013.

However, whilst the economic outlook for the eurozone is poor, with the ECB forecasting, as the mid point in its range, economic contraction of 0.3% in 2013, investors should not allow themselves to believe that the area should be avoided as far as equity investments in good companies are concerned. Their international companies have widespread reach including areas of the world which are growing much faster than the west. Importantly, valuations remain attractive. If we look at the Euro STOXX 50 Index, which is the leading blue chip index for the eurozone, we see an estimated dividend yield of around 4.0% for 2012 and a price/earnings ratio of around 11.5. When we look at the redemption yields on high quality sovereign bonds and take into account the prospect of some dividend growth, the attractions of eurozone equities are, to us, apparent. It does not need rapid economic growth, which we will not get anyway, to justify these yields and ratings. We think that they stand up on their own. Outside the eurozone stands Switzerland which, too, has experienced an excellent year with its relatively small collection of world class companies. It is more highly rated as a market than the eurozone but we think that is justified by the perceived stability of the country economically and by the large proportion of Swiss companies’ earnings which come from overseas.

So, whilst there have been further detailed developments within the eurozone in 2012, the fundamental problem of the monetary union remains and there should be no feeling that the eurozone is nearer a resolution to its problems, just because most eurozone equity markets have recovered.

In the USA, the November elections reinforced the status quo with the Democrats retaining the White House and control of the Senate whilst the Republicans retained the House of Representatives. Although the Presidential vote was close in percentage terms, the feeling is that such momentum as there is lies with the Democrats in the budget negotiations. Immediately after the election, Wall Street fell back because the status quo had been maintained, increasing fears about the “fiscal cliff”. The “fiscal cliff” refers to automatic tax increases, payroll tax relief holidays, extended employment benefits and automatic spending cuts which would have come into force from 1st January 2013 if no agreement on a budget and debt ceiling could be agreed. It will be recalled that in 2011, when there was a stand off over raising the debt ceiling, the markets took this very badly. In full, if the “fiscal cliff” had occurred, the effect on GDP is estimated at about 4% of GDP, in money terms just over US\$600 billion. The Congressional Budget office said, in August, that, if the “fiscal cliff” occurs, growth in 2013 would be just 0.5% and unemployment 9.0% by the end of 2013 (it is currently 7.7%). If the “fiscal cliff” does not occur because the tax cuts etc are extended indefinitely, then growth would be 1.7% and unemployment would be 8% by the end of 2013. The budget deficit would be US\$1 trillion (US\$1.089 trillion in the year to September 2012). These figures are frightening, even for a country like the USA whose currency is the largest component of the world’s foreign exchange reserves and which can print its own money unlike individual eurozone countries.





The problem is the highly partisan nature of US politics and the problem is getting worse with very little centre ground. The Republicans do not like tax increases and the Democrats do not like spending cuts, particularly on entitlements. As this is written immediately after the year end, agreement has been reached on tax rises for the wealthy and the ending of the payroll tax holiday. This, at least in the short term, has been greeted strongly in the stock market although it is only the revenue side of the equation which was covered. However, the even harder decisions on spending cuts and the debt ceiling will have to be made in two months' time and the Republicans, having given some ground on tax increases for the wealthy, are likely to be on stronger ground on these issues and to be more united. So the crisis might return soon and there is no reason to be optimistic about a bipartisan agreement on an issue which divides the two US parties so strongly. As it is, what was agreed over the year end represents a drag on the US economy of about 1.5%, it is estimated.

Whilst the fiscal outlook is unclear, monetary policy is easier to forecast because the Federal Reserve has said what it is going to do and we think, as elsewhere, that the policy is going to be supportive for markets in the foreseeable future even if, longer term, monetary policy, not only in the USA but elsewhere, is storing up inflationary problems although those are for another day. Relatively speaking, the US economy is performing reasonably well. In fact, the latest revision to third quarter GDP figures suggests annualised growth of 3.1% against the previous estimate of 2.7%. The upward revision was due to higher net exports than previously calculated as well as consumer and government spending. But the big news, apart from the "fiscal cliff" concern, is that the Federal Reserve, which has a wider remit than many other central banks, is tying its monetary policy to the level of unemployment, albeit with a caveat about inflation levels. It has indicated that it will keep interest rates at close to zero until the unemployment rate falls below 6.5% which, as we have indicated above, compares with the current level of 7.7%, so there is quite some way to go before it gets down to the target level. The caveat on inflation is that it would continue to target near zero rates provided inflation expectations did not rise about 2.5%. The Consumer Price Index is currently 1.8% year on year. At the same time, the Federal Reserve raised its third round of quantitative easing to US\$85 billion a month. This comprises US\$40 billion of mortgage backed securities and US\$45 billion of Treasury purchases. So, whilst US fiscal policy is unclear, monetary policy is very aggressive as it is used to try to stimulate the US economy.

Whilst the confrontational nature of US politics means that assuming a rational outcome to the fiscal stand off is not necessarily right, as investors we think we have to assume a positive outcome if only because we know that monetary policy is going to be so stimulative. In the absence of any other attractive mainstream US assets, although US equities are traditionally quite low yielding, the extraordinarily low yield level on US Treasuries (see our table at the beginning of this review) means that US equities, as elsewhere, have yield attractions. According to Bloomberg, the estimated dividend yield on the S & P 500 Index for 2012 is about 2.24%, whilst the price/earnings ratio is about 13.8. These do not look expensive for an economy which is showing modest growth. Whilst we have been talking about the short term problems of the US economy, if we look further ahead, there is one large positive factor for the US economy surrounding its huge shale oil and gas reserves which promise to bring down manufacturing costs in the USA and to improve its current account position and support the US dollar. Already, some US companies are building plants in response to the improved profitability prospects for their products arising from lower input costs.

Although the Japanese stock market performed well in local currency terms in 2012, the weakness of the yen substantially reduced returns for overseas investors. The weakening of the yen is good news for Japanese exporters' shares which have shown a significant price recovery following the sharp fall in the value of the yen in recent weeks. The dramatic move in the yen is due to the prospect and, now, realisation of a change of government which has seen the LDP return to power under Mr Abe who has been Prime Minister before. Japan's financial and economic problems are severe as we have often discussed with dire public finances represented by a large current budget deficit and the largest level of outstanding public debt in relation to GDP of any major industrialised



country, around 230% of GDP at the gross level. Furthermore, its demographics are awful. What has been helpful in staving off trouble in international financial markets has been low foreign ownership of Japanese government debt and the country's current account surplus. However, there is no guarantee that this state of affairs will last as, for example, Japan's current account deficit declines. The closing of most of Japan's nuclear power stations following 2011's earthquake and tsunami has meant more imports to provide for domestic energy consumption which is no longer provided by nuclear power. The trade deficit which has emerged has not yet put the current account into deficit but it is deteriorating. The new Prime Minister has been exerting pressure on the Bank of Japan to ease monetary policy further even though the central bank is independent. The urgency of some type of action is shown by the 0.9% fall in third quarter GDP compared with the second quarter. Mr Abe has pressured the Bank of Japan to target a 2% inflation rate rather than a 1% one. Following the election result in December, the Bank of Japan has raised its asset purchasing programme by JPY10 trillion (US\$118 billion) and suggested that it could target a higher inflation goal. The Bank of Japan's additional purchases will comprise Treasury bills and Japanese government bonds. With such a horrendous public debt position, fiscal policy has to be tightened and the doubling, in two stages, of Japanese consumption tax, currently 5%, is planned. When it was increased in the late 1990s, it stalled the economy but expenditure and revenues are so out of line that something has to be tried and, as elsewhere, a tightening of fiscal policy is being accompanied by a loosening of monetary policy. A budget deficit of around 10% of GDP is not sustainable, particularly with such a high level of overall public debt. Besides the energy problem and the political stand off between Japan and China over the disputed islands, which is affecting Japanese business, the country faces increasing competition from elsewhere in Asia with Korean companies doing particularly well in areas in which Japan has historically been strong. The overvalued yen has not helped so, in this respect, Japanese companies are getting some respite. Japan will be an interesting country to watch in 2013 as a result of the election result and the aggressively pro growth stance of Mr Abe.

All eyes, of course, are on China which had been slowing down for a number of reasons including government attempts to keep inflation low and difficult export markets. But a loosening of policy once inflation had fallen to acceptable levels appears to be having a positive effect. For example, there has been an improvement in the purchasing managers indices both for manufacturing and services and some rise in house prices with new house prices in October rising in 35 out of 70 cities tracked by the National Bureau of Statistics. The figure in September was 31. Industrial output year on year in October was 10.1% higher compared with 9.6% in October and there was also an acceleration in the rate of increase in retail sales in October, up 14.9% compared with 14.5% the previous month. Sales of new houses for the first eleven months of the year were up 9.1% which was 3.5% higher than a year earlier whilst the increases in property investment were 16.7% and 15.4% on the same basis.

The story has also been about political change and we will have to see how, if at all, the new leadership takes a different path. There is not much evidence on this yet. However, from an economic perspective, there is reason for some modest encouragement from the economic news emanating from China.

For the UK, conditions remain very tough with the Chancellor having great difficulty in containing the UK's huge borrowing requirement. He has not been helped in his task by the very difficult conditions in the eurozone and the fact that inflation has consistently been above target which has depressed real incomes and subdued consumption. At this stage of the year, excluding special factors, the deficit for this financial year is £8.3 billion higher than the equivalent figure a year ago. Furthermore, S & P has joined Moody's and Fitch in putting the UK on negative credit watch. The Office for Budget Responsibility (OBR) has downgraded its economic forecast for the UK so that it now expects the economy to contract by 0.1% in 2012 and to grow by 1.2% in 2013 against its previous forecast of 2.0%. Lower than forecast growth means raised public borrowing expectations. The latest purchasing managers indices for manufacturing, services and construction are hovering around 50 implying no real movement in the economy and the latest revision to third quarter GDP figures was slightly downwards to 0.9% against 1.0%. The housing market, too, seems becalmed with house prices, if anything, falling. But there



is one piece of relatively good news which appears at odds with the rather gloomy GDP figures and that is the employment report which has consistently suggested a stronger economic performance. In the three months to the end of October, employment rose to its highest level since records began in 1971 with the number of people in work increasing by 40,000 to 29.6 million in the three months to October. Looking at the optimistic interpretation, it could be that recent GDP figures have underestimated the strength of the UK economy.

The state of the UK's public finances is desperately bad. It retains the advantage over similarly troubled eurozone countries in that it issues and can print its own money. Very tough decisions, as elsewhere, have to be made and these will no doubt bring in further unpopularity for the government. The UK, notwithstanding the credit rating agencies' concerns, does seem to have retained the confidence of bond investors but, were the government to heed the siren voices calling for more public spending, that would soon evaporate.

As elsewhere, government bonds look very expensive and equities reasonable value with many world class British companies delivering significant earnings from faster growing parts of the world.

In summary, our message is much as it was a year ago. Despite all the serious economic and financial problems of the world, not to mention the political ones, we consider equities to be the asset of choice. We consider that they are reasonably valued, even in the context of a world economy which is going to show only modest growth in 2013, with earnings multiples and dividend yields attractive, especially against most competing assets. They will, however, almost certainly be volatile, providing an opportunity to commit further funds to equities for those maintaining a reserve of cash. There is still a lot of bad news around. Bonds, for reasons we have mentioned, look very overpriced. We know why, but it does not alter the fact that yields are out of touch with reality. Although the stock market rose in 2012, it was not for the best of reasons but, rather, caused by the extremely loose monetary policy which has been followed out of desperation by governments and central banks. As we see it, 2013 looks like providing more of the same.

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