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ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

The quarter ended on a poor note with anxiety levels rising again as a new round of financing for certain financial institutions was undertaken. As yet, no “green shoots” from the massive monetary and fiscal stimulus given to the world economy have appeared. Every economic cycle ends and they will start to appear. Waiting for that to happen is a nervous time and this is where we are at present.

The tables below detail relevant movements in markets :

International Equities 28.11.08 - 27.02.09

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	-9.7	-4.7	-11.5	-11.5
Finland	-27.6	-21.9	-27.5	-27.6
France	-16.4	-9.9	-16.3	-16.4
Germany	-17.9	-11.5	-11.5	-17.9
Hong Kong, China	-0.7	+6.9	-0.7	-0.8
Italy	-21.9	-15.9	-21.8	-21.9
Japan	-9.4	-5.1	-11.8	-11.9
Netherlands	-11.9	-5.1	-11.8	-11.9
Spain	-14.4	-7.8	-14.6	-14.4
Switzerland	-18.1	-8.1	-14.3	-14.7
UK	-9.7	-9.7	-16.1	-16.2
USA	-16.6	-10.3	-16.6	-16.7
Europe ex UK	-16.1	-9.5	-16.0	-16.0
Asia Pacific ex Japan	-3.6	+1.1	-6.0	-6.1
Asia Pacific	-7.1	-2.5	-9.4	-9.5
Latin America	+2.7	+5.0	-2.5	-2.6
All World All Emerging	-2.1	+2.0	-5.3	-5.4
The World	-13.6	-8.2	-14.7	-14.8

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +1.8%

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

Currency	28.11.08	27.02.09
Sterling	3.78	3.61
US Dollar	2.93	3.04
Yen	1.40	1.27
Germany (Euro)	3.26	3.12



Sterling's performance during the quarter ending 27.02.09 (%)

Currency	Quarter Ending 27.02.09
US Dollar	-7.1
Canadian Dollar	-5.0
Yen	-4.6
Euro	-7.2
Swiss Franc	-10.9

Other currency movements during the quarter ending 27.02.09 (%)

Other Currency	Quarter Ending 27.02.09
US Dollar/Canadian Dollar	+2.2
US Dollar/Yen	+2.7
US Dollar/Euro	-0.1
Swiss Franc/Euro	+4.2
Euro/Yen	+2.8

Significant Commodities (US dollar terms) 28.11.08 - 27.02.09 (%)

Significant Commodities	28.11.08 - 27.02.09
Oil	-13.3
Gold	+17.1

Markets

The economic and financial news has found its reflection in the performance of stock markets during the last quarter. In local currency terms, the FTSE World Index showed a negative return of 13.6%, 8.2% in sterling terms, 14.7% in US dollar terms and 14.8% in euro terms. In local currency terms, the only positive return was from the FTSE Latin American Index which returned 2.7%. Elsewhere, the least negative local currency performances came from the FTSE Japanese Index (-9.4%), the FTSE UK Index (-9.7%), the FTSE Australian Index (-9.7%), the FTSE Asian ex Japan Index (-3.6%) and the FTSE All World All Emerging Markets Index (-2.1%). Performing worse than the FTSE World Index in local currency terms were the FTSE USA Index (-16.6%) and the FTSE Europe ex UK Index (-16.1%). As the movements in the currency adjusted FTSE World Index above show, sterling again performed badly and this had a significant effect on the sterling adjusted indices. The FTSE Latin American Index, the FTSE All World All Emerging Market Index and the FTSE Asia Pacific ex Japan Index all returned positive performances, 5.0%, 2.0% and 1.1% respectively in sterling terms. Australia held up relatively well (-4.7%), whilst the negative returns in the USA and Europe ex UK were reduced to -10.3% and -9.5% respectively, close to the return on the FTSE UK Index -9.7%.

Bond markets, as measured by ten year government bond yields, were little changed over the quarter although within the eurozone bond market, as we shall discuss later, the steady performance of the German government bond market does not reflect the stresses within the eurozone government bond market. Gross redemption yields on sterling bonds fell by 17 basis points to 3.6%, on US government bonds they rose by 11 basis points to 3.04%, on yen bonds they fell by 13 basis points to 1.27% and on German government bonds they fell by 14 basis points to 3.12%.

Currency movements over the quarter have been significant with sterling falling sharply even though it made some recovery in the New Year. Over the quarter it fell by 10.9% against the Swiss franc, 7.2% against the euro,



7.1% against the US dollar, 5.0% against the Canadian dollar and 4.6% against the yen. Sterling based investors with international exposure therefore had some respite from the worst of the fall.

In the commodity markets, oil continued to fall, being down by 13.3% over the quarter, whilst gold rose by 17.1%.

Economics

The torrent of bad and, sometimes, unbelievable economic and financial news continues. We are truly in uncharted territory. The news seems only one way at present, which is bad. However, by definition, all cycles have troughs and, so, objective analysis is more important than ever at a time when it is, understandably, easy to be stuck in a slough of despond.

As in recent quarters, rather than analyse individual economic numbers which are soon overtaken by events and are therefore of less use than usual, we will discuss the present outlook in general terms and try to look for some pointers to the future.

In one way, the situation with the banks is better and, in other ways, it is worse. It is better to the extent that depositors feel more secure as a result of the measures taken by governments and central banks to safeguard deposits. Last October, there was a real fear over the security of deposits and, bad though things are at present, a run on banks would have had incalculable consequences. The failure of a major bank would have been devastating, risking economic collapse. Through a variety of measures such as nationalisation, part nationalisation and deposit guarantees, depositors' confidence has returned to a greater or lesser degree. That, at least, is progress from the situation which threatened last autumn. The way in which the position has worsened is that bank losses and write downs have grown. Governments and central banks have reacted to events in a piecemeal fashion, often ending in putting even more taxpayers' money into the relevant banks to improve their capital ratios. Amongst others, the US, UK and some European governments have ended up owning banks and other financial institutions or having a significant minority interest in a number of them. Given the size of banks relative to their economies, some of these commitments are vast. This is mainly a western phenomenon. Asian banks have tended to avoid the worst of the mistakes, with most of the excesses having taken place in the West. We can probably say that, serious though the position is with some banks, governments and central banks are learning how to react to a further deterioration in some banks' financial position in such a way as to reassure depositors. The cost is vast but the alternative of letting commercial banks fail would be much larger, indeed it would be unthinkable. Some progress in reassuring depositors has been made in this respect and, if the news on losses becomes worse, more of the same may be expected.

The second part of the problem has not been solved. This is the need to provide an adequate flow of funds to businesses and individuals to ensure that their reasonable needs are met and that the economy can function properly in the short term and move to a growth path in the medium and long term. Because banks are still in a state of shock, they are reluctant to lend, preferring to hoard cash, because they are uncertain of the creditworthiness of other banks, or retain funds for meeting commitments to customers under agreed credit facilities. The fear is that healthy businesses fail because they are unable to obtain finance. Whilst the housing market was certainly well into bubble territory and a correction is healthy for the longer term stability of the economy, the difficulty of obtaining finance for house purchase threatens to cause prices to fall below a level which might seem sustainable in more normal times. The number of homeowners affected by negative equity is bound to increase and the more this occurs the more consumer confidence weakens and the greater the negative effect on the rest of the economy.

A variety of methods is being used around the world to achieve these aims including the guaranteeing of bank debt, central bank loans and the purchase of a wide range of assets by central banks with the resultant assets offered by the central banks in return, such as Treasury Bills, being much better quality assets against which banks can borrow. We are also in the realm of moving towards the modern equivalent of printing money, "quantitative easing", where a central bank, in return for buying assets from holders of, say, gilts or corporate bonds, can credit



the sellers with the proceeds created electronically rather than funding the purchase by selling, say, Treasury Bills. This is expected to start shortly in the UK. The idea is that by swelling the amount of cash deposits at banks, this will push down interest rates and encourage bank lending which will stimulate economic activity.

As far as lending to businesses and individuals is concerned, it is not only the availability but the cost which is important. In this respect, interest rates have been cut dramatically. Initially, the lack of mutual trust between banks meant that interbank rates in relation to official rates were very elevated. The whole point of cutting official interest rates is that the transmission effect to borrowers should work. This did not happen at first as banks were frightened to lend to each other so the effect of lower official interest rates was very weak. As central banks have moved to ease interbank market tensions in the way described, so the margin over official rates has moved to more normal levels though they are still slightly elevated. Now, official efforts are concentrated on encouraging banks to lend. However, the authorities have to be careful. As they say, we are where we are and we have to look forward. There is no point in pressurising banks to make loans which do not stand up commercially. Banks have to make profits to rebuild their capital base, otherwise we will be back where we started. Whilst the banks make easy prey for politicians in the current febrile environment, hit them too hard and a bad situation will be made worse. Companies will want credit facilities remaining in place and do not want to be starved of cash which could threaten their existence. Measures currently being taken to reduce the fear amongst banks either regarding their funding or their lending should help.

In the haste and urgency of governments' and central banks' efforts to kick start the world economy, we must also consider the risks which are being run in the medium and long term with regard to inflation. In terms of the modern day equivalent of printing money, quantitative easing aimed at increasing money supply growth, inflation risks are being run for the future. Current fears about disinflation, which is occurring at present, and even greater concerns about the possibility of deflation, could well remain a distant memory if current economic easing, both by monetary means and fiscal means, is not reversed at the first suitable opportunity. Monetary policy is probably the easier to reverse because, in many cases, it is controlled by independent central banks. Current negligible official interest rates are not sustainable unless, as is unlikely, there is a prolonged period of deflation. In normal economic times, where inflation exists, negative real rates threaten to raise inflation levels. So it is important, as the world economy recovers, as it will eventually, that interest rates are raised to more normal levels which would imply a positive real rate of interest. Fiscal policy, which is out of control in many economies, will be harder to correct as it is controlled by politicians. Deficits of the order being run in many countries threaten a number of unpleasant consequences. Inflation is an obvious one, very high interest rates another and defaults are a third. "Crowding out" of the private sector is a fourth consequence, as large government borrowing requirements push up interest rates and make life more difficult for the private sector. If, as, say, in the UK, a significant minority of government debt is owned by foreign investors and the latter take fright, then the currency will weaken and interest rates rise. Whilst, ultimately, a country can resort to the modern day printing press, the currency loses value internationally and inflation threatens. These are extreme situations being described but make the point that it will be vital that order is restored to fiscal policy in the countries which have dangerously large fiscal deficits. How these deficits are tackled is important. Tax increases will depress economic activity yet spending cuts are difficult politically for some governments. It is easy to see governments dragging their heels in attending to fiscal deficits once we are past the worst of the present crisis, yet the longer action is postponed, the worse will be the long term outcomes. Once there has been destruction of wealth on the current scale, recovery becomes slower and has to be nurtured carefully through appropriate economic measures. Politicians will find this much harder to achieve than central bankers. If politicians do not do their job then central bankers may have to overcompensate on interest rates. For these reasons it is likely that economic growth will be modest once it restarts, as a lot of fiscal and monetary clearing up will have to be done.



An area where problems are building up is Europe, with particular reference to strains in the eurozone bond market and the indebtedness of some eastern European countries, which could present a problem for some eurozone banks. The European Monetary Union was always a political project; the economic justification was always thin in our view, because the initial countries comprising the eurozone were a disparate collection of countries and this view has been strengthened as the number of countries in the eurozone has increased. Far from converging economically, as was the plan of EMU, the countries have moved further apart than ever. Because the politicians have a vested interest in denying fundamental problems with the concept, the answer to its increasing problems is unclear.

The root cause of the problem has been the “one size fits all” monetary policy. It was always clear that this single interest rate policy had the potential to cause real trouble and that has turned out to be the case. Interest rates set too low fuelled the property boom in Spain and Ireland and, now that the boom has turned to bust, these countries are left with severe problems. Different inflation levels since EMU have led to some countries losing competitiveness. Countries like Spain, Italy, Greece and Ireland come to mind. Now that they are unable to devalue their way out of the problem, they are faced with some unpleasant choices. If a country is unable to devalue in order to regain competitiveness, then a reduction in real wages is necessary. But is that really practicable? One can already see the stirrings of social unrest in some eurozone countries and that surely would be a step too far. More subtly, because the fiscal position of a number of eurozone countries is shot to bits and way outside the bounds of acceptable deficits ordained under the Stability and Growth Pact, strong measures to improve the fiscal position could result in much higher unemployment and stoke unrest that way. Yet one of the cornerstones of the euro concept is the acceptance of fiscal discipline. It is extremely difficult to see how this can be restored in the foreseeable future and, whilst this discipline is elusive, confidence in the euro is bound to take a knock.

Our belief at the outset was that, at some stage, the eurozone might fragment because it did not seem to be an optimal currency area. Very few people saw it that way and, certainly, the political elite of the eurozone would not even countenance the suggestion. That still remains the case today. However, amongst independent commentators, the idea is no longer dismissed. It remains a minority view but it is gaining strength. One thing is for certain which is that the present position is unsustainable. The present very low ECB interest rate of 1.5% is less unsuitable for the eurozone as a whole when activity is depressed than the uniform interest rate was when the eurozone was growing at different rates amongst its members. At that time interest rates were too low for countries that were growing too quickly and experiencing unsustainable housing and construction booms. National governments were powerless to use the most obvious economic weapon to restrain such excesses, interest rates. This has contributed towards the serious problems which Ireland and Spain are currently experiencing for example. The damage which the “one size fits all” monetary policy has now done is probably beyond repair. Indeed, it has resulted in differentials in eurozone bond yields which imply different monetary policies anyway. The downgrading of the sovereign debt ratings of Spain, Portugal and Greece, for example, implies economic divergence rather than convergence. If we look at the spread of ten year eurozone government bonds against the best credit, Germany, we see how serious the position has become. At the end of February, in ascending order of spread, we see the following spreads against German bonds - France 52 basis points, Finland 80, Netherlands 81, Belgium 110, Austria 111, Spain 118, Italy 156, Portugal 172, Greece 248 and Ireland 262. A seriously deteriorating fiscal position in most of the eurozone, which therefore entails increased borrowing, results in a snowball effect of rising interest costs, a rising debt burden and increased investor concern about certain countries' ability to repay their debts.

What are the possibilities for the eurozone in this scenario which is unfolding? There is no mechanism for a bailout so some response will have to be drawn up to deal with the situation. Leaving the eurozone, previously unthinkable, might not be so now. Because EMU was a political concept, there exists no exit mechanism. Leaving



the eurozone and being reunited with a devalued currency, which is what the currency would be, will increase liabilities denominated in euros. At a country level, this could possibly be accommodated by a debt restructuring but, at a corporate level, it could prove deadly for companies with euro borrowings. So, leaving the eurozone would be fraught with difficulty. But, if that is difficult, the alternative of maintaining the status quo in any time horizon other than the near term, would seem to offer an even more difficult path towards restoring economic stability. As we mentioned above, lost competitiveness is very difficult to reverse and, in the eurozone, perhaps particularly difficult because of economic rigidities. It will simply not be possible to restore competitiveness by cutting real wages. A foretaste of things to come was the recent large demonstration in Dublin by public sector employees protesting at the proposed pensions' levy and this happened in one of the eurozone's more flexible economies. It would be very surprising if the loss of competitiveness of certain economies within the eurozone could be reversed by cuts in real wages. There is a related issue here which is how strongly the Stability and Growth Pact will be enforced. At the moment, it has been shot to bits by the recession. At present, attempts to enforce budget deficit limits would worsen the recession, yet lack of adherence to them increases economic divergences. Germany is an important consideration here. As a country which was reluctant to give up the Deutschmark and for which financial discipline remains paramount, the idea of fiscal policy discipline being abandoned by other members of the eurozone, thereby perhaps tainting the euro, was and still is unthinkable. The financial problems of eastern Europe and the heavy involvement of some eurozone banks, Austria particularly comes to mind, has raised the issue of Germany leading a financial bailout of any eurozone country which gets into trouble. This is a prospect which is not likely to go down well in Germany, firstly for historical reasons just given and, secondly, because although relatively well placed, Germany is also suffering acutely, with exports, a bedrock of the economy, being badly affected by the downturn in world trade. By itself, even if it wanted to, Germany could not do it.

The status quo within the eurozone is not a realistic option. Countries like Greece, Spain and Ireland, have problems which will not easily be resolved within the current structure. Loans come with conditions and the European psyche is not to accept economic change easily. That is why the unthinkable, but an unthinkable which is beginning to be talked about that one or more countries might leave the eurozone, is a strong possibility in our view. Concerns about this are evidenced by some recent weakness in the euro, even against sterling. Even though sterling has experienced a significant fall against the euro over the last quarter, it has recovered from its lowest levels against it since the end of last year. Whilst we remain very concerned about the UK's economic position, the problems within the eurozone may continue to weigh on the currency. That does not necessarily mean that it will fall against sterling since the problems of both areas are serious.

For the wider EU as well, the problems of eastern Europe are becoming a major headache. Many individuals in this area borrowed for, say, house purchase in lower interest rate currencies, such as the Swiss franc, to avoid the much higher interest rates of, say, Hungary, to give one example. Such a policy was always likely to end in grief which is now what is happening.

If one had to guess at what might be one of the main economic issues this year, amongst many, it would be developments within the eurozone and the wider EU.

Whilst we have deliberately not dealt with specific economic data as we usually do in these reviews because they are so quickly overtaken by events, it is right to mention countries where we think the problems are relatively greater. All countries and regions are suffering except for certain special cases such as some of the oil rich Middle Eastern economies where falling oil and gas prices can be accommodated through the huge financial reserves built up over the years. But it is a zero sum situation - some are relatively worse off than others. Not all currencies can go down together. Some have to gain relative to others. As we have just discussed, we think Europe (ex the UK) has particular problems and we think the UK does, too.



Clients will know that we have, for a long time, been particularly concerned about the UK and cautioned that sterling looked vulnerable against an unsupportive background. For a long time, sterling defied economic gravity, supported, amongst other factors, by foreign takeovers for cash of British companies. That has all come to a halt and the weak internal and external financial position highlighted by, amongst other factors, the importance of the finance sector to the UK economy, brought a sharp fall in sterling in 2008. Whilst a government anywhere might, naturally, try to paint as favourable a picture as possible of the economy it runs, the foreign exchange market will provide a more objective assessment and, in 2008, it told us that it did not like the look of the UK economy.

Well before anyone appreciated the gravity of the financial crisis to come, we were concerned about the state of the UK's public finances which, for years, had been giving off warning signs. Independent observers were warning that the government was borrowing too much and the Treasury's forecasts for government borrowing were, for many years, always too optimistic. If the government is borrowing too much when the economy is apparently growing quite strongly, it is in no position to face with any confidence an economic downturn. If times are good, governments should be putting money by for bad times.

A good example of how it should be done is in Australia where, as a result of strong economic growth and financial discipline, the government has been able to use fiscal measures to try to offset recessionary influences. In the UK, the poor state of public finances coming into the recession has left the economy vulnerable to a number of threats, exacerbated by the need to provide vast sums of support for the banking system. In no particular order of threat, we can consider that to the tax base of the country. At around 10% of GDP, the finance sector is important. The erosion of the tax base from the collapse or elimination of corporate profits in the finance sector and the loss of income tax on earnings and bonuses, is highly damaging to public finances. Weakness in the housing market is damaging revenues from stamp duty. On top of these threats to tax revenue, which are particularly serious to the UK economy, there are the normal causes of damage arising from a recession which is the weakness of revenues from corporate taxation (besides, specifically that from the financial sector), personal taxation (as unemployment rises) and indirect taxation (as consumers rein in their spending). On the expenditure side, rising unemployment raises government spending. These are the normal automatic stabilisers for an economy operating in a recession. The problem is that these are operating on the back of a large structural deficit in the UK economy, rather than just a cyclical one, and this provides an even more dire outlook for the UK's public finances than at present. The Treasury will have to revise its previously far too optimistic forecasts for government borrowing and we are looking at government borrowing figures for the coming financial year, and the one after that, possibly quite well into double figures as a percentage of GDP. Whilst the government has pointed to the UK's relatively low overall level of debt as a percentage of GDP coming into the recession, that is not really the point. Current borrowing figures, such as those projected by many independent commentators, are unsustainable, require major corrective action and pose many serious threats to the UK economy. Although we are in a disinflationary environment at present and gross redemption yields on UK government bonds at the medium and long dated end may not seem unreasonable at over 4%, the present economic policy being followed and the results of sterling's large devaluation last year threaten to raise inflation, and, not to mention the vast issuance of government debt, all threaten to make current yields unsustainably low.

Planned quantitative easing to boost money supply growth by way of bank deposits created through the central bank's purchase of certain assets threaten to cause inflation down the line if action is not taken to reverse the position as soon as it is safe to do so. Although the Bank of England is independent, it has sought and received permission to start quantitative easing. Whether the Treasury will be willing to give orders to reverse the process when the time comes, we will have to wait and see. There is talk of deflation at present and the unpleasant consequences of it, but we think this is unlikely to happen in the UK. Even in this very depressed environment, manufacturers experienced a 1.5% increase in input costs in January and there was a 0.1% increase in factory gate prices in January. The year on year retail prices index in January was up 0.1% year on year helped by the fall in mortgage costs, but the government's preferred measure, the consumer price index, was up 3.0% year on year and the core



inflation rate rose from 1.1% to 1.3% in January. Food price inflation, much less susceptible to fluctuations in economic activity, was up 10.1% year on year. The very substantial devaluation of sterling last year has yet to work its way fully through the system. Whilst extreme competitive pressures in the retail sector will blunt some of the imported price increases, these cannot outweigh the effects of imported inflation through devaluation.

Another threat to the UK economy, arising out of the dire state of public finances and the need to raise vast sums of money in the debt market, is of a buyers' strike. Nearly every government is having to borrow vast sums of money and the appetite of international investors will be severely tested. There is every chance that the price of money, i.e. interest rates, will rise in the face of the extraordinary demand for bonds. If it does, financing government debt, the rising cost of which is restrained by low interest rates, will become an even bigger burden. It is estimated that about a third of the gilt edged market is held by foreign investors at present and therein lies another potential problem. Foreign investors in UK government securities suffered a significant loss on the exchange rate last year. Should the state of the UK economy cause particular concern to overseas investors, the significant proportion of debt held by them could be destabilising to the exchange rate if their concerns caused them to sell part of their holdings. Such a poor financial position, as is the case in the UK, leaves a country at the mercy of outside factors. There must also be an outside concern about the UK's sovereign debt rating, currently the top AAA. If that were to be threatened with a downgrade at any time, the cost of finance would be raised and perhaps some holders would have to sell debt if they could only hold AAA rated issues. The electoral cycle in the UK is working against early action to deal with the UK's public finances. With the next General Election most likely to be held next year, it will not be easy, politically, for the government to take corrective action with the economic outlook poor and, so, our relative caution in the UK remains, but a good way for equity investors to protect themselves against any possible further dangers of sterling weakness remains exposure to large UK companies with substantial overseas interests. This is important in the context of a difference of 20% in the returns on the FTSE World Index in local currency terms last calendar year and its sterling adjusted figure.

One could go on to query why the UK may be considered to be a bigger risk for investors than the USA where similarly vast deficits in relative terms are being run. The answer may be very simplistic and lacking in fundamental justification but it is, nevertheless, likely to be true. That is, that the sheer size of the US economy and the liquidity of its markets, plus the fact that the US dollar is used as the transaction currency in money markets, means that there is a need to hold US dollars. There is not the same need for sterling or the other major currencies. This gives the US dollar some advantage even when the country is running large current account and budget deficits. As the major reserve currency, size gives the USA a big advantage though it is not one which can be taken for granted.

Where does all this leave us? At present, it is difficult to believe that the news can be any more depressing. There seems no end to the bad news. But, whilst it is an obvious thing to say, every downwards economic cycle comes to an end and, gradually, the news becomes better, even though it is still outweighed by bad news. Eventually, the balance of the news becomes positive. What might turn things round? Firstly, it could be the sheer weight of money thrown at the problem including quantitative easing. We use this term loosely, but we mean the combined effect of monetary and fiscal policy, plus efforts to restore confidence in banks and giving them enough confidence to lend to worthy borrowers. Secondly, as a result of disinflation and lower interest rates, some businesses and individuals will gradually feel more confident to spend. One must remember that the enormous fall in oil prices, for example, has meant a huge transfer of wealth from oil producers to consumers. Offsetting this, to an extent as yet unknown, is the effect on the spending habits of those who rely on interest income. It is estimated that, in the UK, there are six or seven times more savers than borrowers. Gradually, we would expect merger and acquisition activity to increase as some companies take advantage of opportunities which they would not have considered realistic before.

We have explained why we think high quality bonds are vulnerable - the inflationary threat down the line and the sheer volume of issuance. We cannot see Bank of England purchases of gilts under its quantitative easing policy will give more than a short term respite to the market. Business will go on and, notwithstanding the threat to



corporate earnings and dividend cuts, there remains value in shares where, even after likely dividend cuts, relative value against bonds looks appealing. Understandably, with the news so depressing and the start to 2009 having been so poor, that is not an easy view to take. Day to day movements sometimes appear to lack any rationale and, undoubtedly, there remain forced sellers who are maintaining the pressure on share prices. There is anecdotal evidence of investors seeking the yield, which they can no longer obtain from bank deposits, from good quality equities. Notwithstanding the uncertainty over dividends, this seems a value option.

On the wider issues, it goes without saying that regulation of the financial services industry will be heavy. In the short term, this may actively benefit investors because it will provide some reassurance against the type of shocks which they have recently suffered. Investors will undoubtedly welcome a very conservatively run clearing bank or insurance company even if its growth prospects seem pedestrian compared with what they had been used to in the past. They will begin to put a premium on not experiencing the type of shocks recently seen. With banks so unpopular, the temptation for politicians to micro manage will be great and the danger is that the pendulum will swing too much the other way. Certainly, politicians, amongst others, have a lot to answer for and, where they are custodian of the public's investment in a bank through a government shareholding, they must allow the bank to operate as commercially as possible, consistent with being prudent, in order to maximise the value of the investment for shareholders.

The hedge fund industry, widely vilified by politicians, will come in for much heavier and wider regulation and, notwithstanding its rapid contraction at present caused by deleveraging and redemptions, it can expect to remain at its reduced size. The industry has also been tainted by the alleged Madoff fraud, and others, and it can be expected to operate under much closer scrutiny.

Finally, a concern for the longer term, which investors must watch when the world economy starts to move out of recession, is the growth of protectionism. Protectionist actions and sentiments gain traction in bad economic times and this is very evident in all sorts of ways, the EU being one good example. The single market theory is in extreme danger at present in the EU where, at the first experience of trouble, countries are looking after their own interests. A fuller discussion of this is for another day. Sufficient to say that protectionism slows economic growth, not a good background for investors.

For the moment, however, we look for emergence of a small number of "green shoots". The world will go on and many businesses survive and then prosper again. Difficult though it is for investors to concentrate upon this at present, it is important to do so for it provides a guide for the future.

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