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ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

Shares have performed well over the last quarter, perhaps out of relief that nothing unexpectedly negative, over and above what was already known, has occurred. Bonds have moved lower, but the real feature has been the currency market where the yen, in particular, but also sterling, have moved sharply lower.

The tables below detail relevant movements in markets:

International Equities 30.11.12 - 28.02.13

Total Return Performances (%)				
Country	Local Currency	£	US \$	€
Australia	+15.1	+19.3	+13.0	+12.4
Finland	+9.4	+16.1	+16.1	+9.4
France	+5.2	+11.7	+9.9	+5.2
Germany	+4.9	+11.4	+5.5	+4.9
Hong Kong, China	+6.0	+11.9	+5.9	+5.4
Italy	-1.7	+4.3	-1.2	-1.7
Japan	+25.4	+18.4	+12.1	+11.5
Netherlands	+2.3	+8.6	+2.8	+2.3
Spain	+4.9	+11.3	+5.4	+4.9
Switzerland	+12.1	+17.5	+11.3	+10.7
UK	+9.3	+9.3	+3.5	+3.0
USA	+7.7	+13.7	+7.7	+7.1
Europe ex UK	+6.7	+13.1	+7.1	+6.6
Asia Pacific ex Japan	+8.6	+13.5	+7.5	+7.0
Asia Pacific	+15.0	+15.4	+9.3	+8.8
Latin America	+2.6	+13.0	+7.0	+6.5
All World All Emerging	+4.3	+10.8	+4.9	+4.4
The World	+8.6	+13.2	+7.2	+6.7

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -1.5%



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

Currency	30.11.12	28.02.13
Sterling	1.79	1.97
US Dollar	1.61	1.89
Yen	0.71	0.67
Germany (Euro)	1.37	1.45

Sterling's performance during the quarter ending 28.02.13 (%)

Currency	Quarter Ending 28.02.13
US Dollar	-5.3
Canadian Dollar	-1.8
Yen	+6.0
Euro	-5.9
Swiss Franc	-4.6
Australian dollar	-3.6

Other currency movements during the quarter ending 28.02.13 (%)

Currency	Quarter Ending 28.02.13
US Dollar/Canadian Dollar	+3.7
US Dollar/Yen	+11.9
US Dollar/Euro	-4.0
Swiss Franc/Euro	-1.4
Euro/Yen	+12.6

Significant Commodities (US dollar terms) 30.11.12 - 28.02.13 (%)

Currency	Quarter Ending 31.01.13
Oil	N/C
Gold	-7.4%

Markets

International equity markets have performed strongly over the quarter. The total return on the FTSE World Index in local currency terms was 8.6%, in sterling terms 13.2%, in US dollar terms 7.2% and in euro terms 6.7%. Looking at local currency returns first, the outstanding performer was Japan with the FTSE Japan index returning 25.4%. We also note a very strong performance from the FTSE Australia index, which returned 15.1%. There were below average but still positive returns from the FTSE Latin America index and the FTSE All World All Emerging Markets index of 2.6% and 4.3% respectively. The picture changes dramatically if we look at sterling adjusted returns. Weakness in the yen has pulled down the return on the FTSE Japan index to 18.4%, still a very strong result and well above the 13.2% return on the FTSE World index. Best of all comes Australia where the return on the FTSE Australia index rises to 19.3%. Most of the other sterling returns are closely bunched, with the FTSE Latin America and FTSE All World All Emerging Markets indices returning 13.0% and 10.8% respectively.



Apart from Japan, where the ten year government bond yield fell by 4 basis points to 0.67%, other high quality ten year government bond yields moved higher. In the sterling government bond market, the ten year government bond yield rose 18 basis points to 1.97%, the US government bond yield by 28 basis points to 1.89% and the German government bond yield by 8 basis points to 1.45%.

There were some major moves in the currency markets, as the currency adjusted performances of different equity markets imply. Against the yen, sterling rose by 6.0% but elsewhere it was very weak. Against the euro, it fell by 5.9%, against the US dollar by 5.3%, against the Swiss Franc by 4.6% and against the Australian dollar by 3.6%.

In the commodity markets, oil, as measured by Brent crude, was unchanged, but gold fell by 7.4%.

Economics

The performance of international equity markets over the last quarter suggests that a significant change of sentiment has occurred and this seems to be the case. Large movements of money into equity funds and talk of a “great rotation” from bonds into equities support this view, although it is still only talk at the present. Investor sentiment can shift easily from seeing the glass “half empty” to “half full” and vice versa without any meaningful reason for the changes. It is also true that many investors are influenced by market trends. So, a rise in international equity markets, such as we have seen, makes investors more comfortable about buying shares and vice versa. It is human nature.

So, what might have caused investors to view the glass as “half full”? Almost certainly, it was initially the speech last summer when Mario Draghi, President of the ECB, vowed to do whatever was necessary to save the euro, effectively through unlimited ECB bond buying in certain circumstances through what will be called Outright Monetary Transactions (“OMT”). For this to happen, countries (at the time Spain and Italy were particularly in investors’ minds) would have to request a bail out but, so far, none has, yet Mr Draghi’s words have had the desired effect on the eurozone bond markets which were thought to be particularly risky, with relevant yields falling sharply. This effect has calmed investors’ nerves and made them more confident about the future of the eurozone. Note that nothing fundamental has changed, merely sentiment, but it has been enough to exert a substantial influence on stock market movements. The second sentiment turner has been developments on the so called US “fiscal cliff”. Immediately after November’s US elections, Wall Street fell quite sharply because the results of the elections for the Presidency and both Houses of Congress maintained the status quo, i.e. stalemate, with the Democrats retaining the Presidency and the Senate and the Republicans the House of Representatives. If no agreement was reached, the US faced a very sharp contraction in its economy as a result of tax rises and spending cuts. In the event, only very limited agreement was reached on one element of the package, the revenue side, but it was enough to instil confidence in the market and, at the time of writing, Wall Street has not looked back. But it is only a part. If no agreement is reached on the spending side, a sequester comes in on 1st March affecting equally defence and discretionary non defence spending and the federal debt ceiling has to be agreed. The Republicans, having given some ground on tax increases, are likely to dig in their heels on spending so there are problems looming. In terms of sentiment, as opposed to fundamental reasons, these two developments have, so far, had a positive influence on international equity markets.

Whilst sentiment has, at least temporarily, swung in favour of equities, it has started to shift against bonds. Our table at the beginning shows a significant uplift in ten year government bond yields over the past quarter. We have long felt that bond yields were detached from reality although, because of very loose monetary policy, both standard (interest rates) and non standard (quantitative easing), one understood why. However, that does not alter the fact that when sentiment turns against bonds, as it may already have started to do, it may initially benefit equities. There is a widespread belief that bonds are less risky than equities but this is not always so. Because,



in our view, bond yields are far lower than they should be, an adjustment in yield levels on ten year government bonds to give a real gross redemption yield of 2%, for example, would lead to a very poor investment result. Whilst it is widely accepted that bond yields are too low, traditional thinking that bonds are safer than shares, or hopes that they could hang on to make a slightly greater gain before selling, may have kept investors invested for a little longer. But, once the trend seems to have turned, one could see a rush for the exit and equities may be beginning to benefit from this, since, in our view, they do not look over priced. This is not yet the great rotation from bonds to equities but, at the very least, we may be seeing a change of emphasis. If we do see the “great rotation”, then the strong upward trend in equities could continue as investors scramble to obtain performance.

Back in the real world, of course, things are very difficult in many countries with the recent positive stock market performance experienced by investors being in stark contrast to life in many countries where economic difficulties are biting hard. Although shares can prosper in difficult economic times, such as we are experiencing at present, and perform poorly in good economic times, we need to be very mindful of the threats to the world economy and the effects which these might have on stock markets. At the moment, there is a disconnection, which we should note, but we emphasise that it does not mean that shares are dear.

Reverting to one of the catalysts for the rise in share prices to which we referred earlier, Mr Draghi’s pledge on the euro, we should note that it was his speech which was so effective in shaping expectations, rather than any fundamental improvement in the currency area’s position. There has been much talk of the eurozone crisis having passed. No such thing has happened. All of the fundamental flaws in the euro’s structure remain. Whilst it could theoretically work if there was a full fiscal union, effectively one economic government, it is almost inconceivable that this could come about. There would be too much domestic opposition. The economic, social and political differences amongst the countries comprising the eurozone are such that the economic convergence implicit in a currency area will not happen. In the absence of the ability to devalue their own currency, which would normally be the chosen course of troubled countries, given their loss of competitiveness against, say, Germany, since the eurozone came into existence, internal devaluations are being forced upon them. This means cutting costs by, for example, cutting pay. The economic consequence of this is that austerity creates a vicious downward economic spiral in the countries affected making budget targets ever harder to meet. If we look at the latest IMF World Economic Outlook, published in January, we note that it forecasts an economic contraction for Italy of 1.0% this year and for Spain of 1.5%. Theoretically, it might be possible to beat uncompetitive economies into economic submission by forcing internal devaluations but, in democracies, this is unlikely to be a realistic option. In Greece, the latest level of unemployment is 27% but, for those between 15 to 24, the level is 61.7%. In Spain, the jobless rate is 26% and, for those between 16 and 24, it is 55.1%. It is unrealistic to think that the electorate will tolerate this kind of level indefinitely and governments will come to power which will reject the austerity measures being imposed upon them and thrust the eurozone into turmoil once again. Because leading eurozone politicians and bureaucrats are so wedded to the concept of the euro, they are pushing ahead with imposing policies on countries that would never be accepted internally if governments were in control of their own destiny. We think that it is an unrealistic assumption that eurozone electorates will take whatever is thrown at them in the way of austerity. Because the eurozone is not an optimal currency area, unnatural attempts to force it to be so will not work and it is almost certain that current policies will have to be amended. In fact, the main test of the eurozone’s resolve may come with France. Although obviously not in a bailout situation, it has budget deficit targets, 3% of GDP for this year, but it is almost certainly out of reach given that the government’s forecasts for growth look over optimistic. It is going to be very difficult politically for the French government to make the necessary spending decisions, having taken the easy populist measures of raising taxes on the rich and large companies. If it does try to tackle public spending more rigorously, it is likely to meet stern internal resistance yet, if it abandons its budget deficit reduction targets, the implications for the eurozone’s credibility will be serious, let alone France’s credit rating. We will come back to this later. Our view remains that, whilst eurozone worries have significantly subsided as



troubled eurozone countries' bond yields have fallen, this does not reflect any progress towards dealing with the euro's contradictions and concerns are likely to emerge again this year. Underlying the dangers for the eurozone of a popular revolt against austerity measures being imposed on their country is the indecisive revolt of the Italian election, where parties opposed to austerity measures are in the ascendancy in the Senate. This has had an immediate effect on the bond yields of troubled eurozone countries.

The second catalyst for the recent rise in international equity markets, the immediate avoidance of the triggering of the US "fiscal cliff" on the 1st January, could still run into problems if the stand off over spending and the debt ceiling between the Republican controlled House of Representatives and the Democrat controlled Presidency and Senate cannot be resolved. The problem was not solved on the 1st January, rather it was just deferred, and, given the antipathy between the political parties, the opportunities for economic accidents to happen are legion. That the USA faces enormous fiscal problems given the trajectory of entitlement spending is well recognised. In terms of the time frame for markets to react to any lack of action on the part of the USA in setting out its long term budget plans, the USA has more leeway than perhaps any other country because the US dollar is the world's largest reserve currency and, therefore, a necessary component of many countries' foreign exchange reserves. However, this advantage will not last indefinitely so, at some stage, the USA will have to address its rising entitlement costs. If it does not, the markets will lose confidence in the USA and its currency. However, this development, assuming no serious effort is made to address the issue, is probably still some way off as other areas of the world have even greater problems.

A third development which helped 2013 to get off to a good start was better news from China where the slowdown in the rate of increase in economic growth seems to have been reversed with some slight acceleration taking place. As the second largest economy, China is watched closely by international investors and, with many parts of the world economy performing poorly, better news from China is well received. We will return to this later.

Overlaying these three specific catalysts for the markets' rise so far this year has been the general driver of asset prices, which we have mentioned in these reviews ever since the dramatic easing of monetary policy following the 2007/8 financial crisis, reflected in both very low interest rates and quantitative easing, where applied. This policy, as intended, though not widely trumpeted at the time, had, as one of its aims, the raising of asset prices to induce a "feel good" factor which might help to kick start the economies of the world following the shock to the system which the crisis caused. This effect continues today. Whilst yields in bond markets can be influenced, to a certain extent, through quantitative easing, when a central bank effectively prints money and buys government bonds or other fixed interest securities, the central bank can control short term interest rates and the hints and statements which we have had from the main central banks suggest they are going to remain very low for the foreseeable future. Very loose monetary policy is being used as an offset to tight fiscal policy where the latter is being practised.

We must be aware that the "quality" of the share price rises we have seen in recent years is not of the highest order. The suppression of short term interest rates and longer term bond yields is driving the search for yield elsewhere, perhaps into equities or much lower quality bonds. Monetary policy is severely distorting markets and, eventually, this position will have to be unwound, otherwise there will be a very unpleasant inflation legacy. That there has not so far been any noticeable inflationary effect reflects a general lack of confidence amongst businesses and individuals but money which has been artificially created has to be withdrawn at some stage because, when it starts to circulate around the relevant economy more rapidly, inflationary pressures will build up. So much money has been created that unwinding the policy is going to be difficult and will take a long time.

The danger is that very loose and unorthodox monetary policy will become a way of life for some countries as they struggle to tackle their public finances, perhaps even leading to debt monetisation. Alternatively, those who believe in conspiracy theories fear that rising inflation, the probable result of current policies, will be used by governments as a way of reducing the debt mountain in real terms.



These twin issues, the search for yield and inflationary dangers, still favour equities as an asset class, provided inflation does not get seriously out of control and, thereby, causing the authorities to act to restrain inflation. That would not be good for equities. Apart from the disconnect between current high quality government bond yields and what one would reasonably expect on pure investment grounds, which suggests highly negative returns from this market, equities should provide some protection against inflation as companies raise prices and dividends. Perhaps an inflation level of 4% - 5% might be tolerable for equity investors. But, if inflation moves out of control and monetary policy has to be severely tightened, then both asset classes would be affected. But, for now, equity investors, whilst certainly not being completely relaxed, can feel reasonably comfortable that they are not holding overpriced assets. However, even though we still favour equities, the news background is likely to provide unpleasant surprises which will result in market setbacks from time to time, albeit probably along a modestly rising trend.

We now turn to look at individual countries and regions, starting with the USA, which hardly grew at all in the last quarter of 2012, just 0.1% quarter on quarter at an annual rate. As discussed earlier on, the major interest for investors was the potential “fiscal cliff” and, as yet, we have only part of the answer. The final quarter of 2012 is likely to have been an aberration in that the weakness was due to federal defence spending and a drawdown of inventories. For this year, in its latest World Economic Outlook, the IMF forecasts that the USA will grow by 2.0%, a marginal reduction on its October projection. In the USA, the non partisan Congressional Budget Office forecasts growth this year of 1.4% and 3.4% next year (the IMF’s forecast is 3.0%). The forecast for this year is predicated on the fiscal tightening which has already begun, or which is scheduled to occur, namely the expiration of the 2% cut in payroll tax, an income tax increase for the wealthy and the sequestration due to come in on the 1st March covering defence expenditure and discretionary non defence federal expenditure. On this basis, unemployment is expected to rise modestly from the current level of 7.9% to stay at around 8%. On this basis, the CBO expects the budget deficit to fall to around 5.3% this year from about 7.0% and to fall steadily to 2.4% in 2015. Thereafter, demographics will turn adverse, raising the cost of entitlement expenditure. In these circumstances, it forecasts that the budget deficit will be 3.8% of GDP by 2023, with government spending accounting for about 22.9% of GDP, and revenue 19.1%. The objective need is for long term political agreement on how to tackle the issue of growing entitlements. Unfortunately, it seems like wishful thinking at present, given the poisonous political atmosphere in Washington. It seems likely that the USA will get away without being punished by the markets for the time being, but not forever, given the unpromising trajectory of public finances.

The Federal Reserve has interpreted its mandate quite aggressively, concentrating on targeting monetary policy at reducing the level of unemployment. It has indicated that it will keep interest rates close to zero until the unemployment rate falls below 6.5% (currently 7.9%) with the caveat that the inflation rate does not rise above 2.5% (currently 1.6%). It raised, at the end of last year, its target for its third round of quantitative easing to US\$85 billion a month, comprising US\$40 billion of mortgage backed securities and US\$45 billion of Treasury purchases. However, as this is written, the US market has paused on upward trend as it was wrong footed by some unexpectedly cautious FOMC minutes from its January meeting. Concern has been expressed by some officials about the size of the Federal Reserve’s balance sheet, currently just over US\$3 trillion. At the above rate of asset purchases it could be around US\$4 trillion by the end of 2013. The risks posed by an increase in interest rates to the portfolio of assets that the Federal Reserve has accumulated are obvious and, it seems, of increasing concern to officials, notwithstanding that it was only at the end of last year that QE3 was launched. The market was spooked, at least temporarily, when the minutes were released on the 20th February because it had not been expecting this level of scepticism so soon after the latest round of quantitative easing was launched. But this reaction, even if it is only temporary, shows how addicted markets have become to money printing and unorthodox policies. We have mentioned that, pleasing though stock market rises are, they have not happened for the best of reasons. The latter would reflect sustainable rates of economic growth and modest inflation rates leading to rises in



corporate earnings and dividends. We have had the last three, and some of the first, in certain countries but some very disappointing results elsewhere, for example, in the eurozone, the UK and Japan. Undoubtedly, however, monetary policy has distorted markets, leading, in our view, to an enormous bubble in bond markets and driving some money into equities. Regarding the latter class of asset, it was our view that they became too cheap after the 2008 fall in markets, but that was because so many people were, quite naturally, fearful about the banking crisis and its implications with respect to the sharp recovery in share prices since the trough in March 2009. We put this down to a realisation that shares were too cheap then, rather than too dear now. Nevertheless, some of the money moving into equities is undoubtedly being driven by necessity, i.e. obtaining yield, rather than a fundamental desire to own shares. We mention this general point in a discussion about the USA because, although we all know that QE is going to have to be phased out, stopped and unwound at some time, it has still come, at least temporarily, as a shock to the market to realise that there are concerns at a high level in the USA about the size of the Federal Reserve's balance sheet. At the very least, it brings to the fore an issue which investors will have to face up to at some stage, namely, the sale of central bank assets back to the private sector.

Notwithstanding the rather freakish fourth quarter GDP figures from the USA, there have been a number of moderately encouraging individual figures published, particularly in the housing area, where the problems all began in 2007/8. For example, starts on single family homes in January were at the highest since July 2008 and building permits at the highest level since June 2008. There was also some encouraging news on the inventory level of unsold homes, which was at its lowest level in January for thirteen years. Between December and January, the number of existing homes available for sale fell by 4.9%, which represented 4.2 months of inventory at the current sales rate, the lowest level since April 2005. Sales, overall, were 9.1% higher than a year earlier. The Purchasing Managers indices, which are watched very closely, make reasonably encouraging reading. The latest figures show the February level of the index for the manufacturing sector at 54.2 against 53.1 in January and that for the non manufacturing sector to be 55.2, against 55.7 (January figures). Both are at levels which imply modest economic growth despite the headwinds of the tax increases and end of the payroll holiday which came into effect in January. At the corporate level, profitability remains high, even though progress is more difficult, and dividends continue to rise. Despite the rise in US Treasury yields, the relationship between the dividend yield on the S & P 500 and, say, ten year US Treasury bonds, still remains historically favourable, even though we would expect yields to cross over, i.e. for ten year Treasury yields to rise above the expected dividend yield on the S & P 500 Index this year. At this stage, we do not see a situation where US corporate earnings are likely to collapse and leave the US equity market looking expensive.

The US outlook is positively rosy compared with that of the eurozone. The latest economic forecast from the European Commission, just published, is for real GDP for the currency bloc to contract by 0.3% this year, little better than the 0.6% contraction in 2012. If we look at the four largest eurozone economies, we note that, for Germany, it expects growth of 0.5% (0.7% in 2012), for France 0.1% (0.0%), for Italy -1.0% (-2.2%) and for Spain -1.4% (-1.4%). For the bail out countries, and here we might add Cyprus now that the election has taken place, the EC's forecasts are for Greece -4.4% (-6.4%), for Portugal -1.9% (-3.2%), for Ireland 1.1% (0.7%) and for Cyprus -3.5% (-2.3%). Even traditionally strong countries like the Netherlands are forecast to be in negative territory this year, -0.6% (-0.9%). If we look at the latest Purchasing Managers Indices, the data that we were just looking at for the USA, we see a gloomy picture which reflects these forecasts. The latest PMI for the eurozone's manufacturing sector stands at 47.9 (47.9) and that for the services sector at 47.3 (48.6), both reflecting the contraction indicated by the EC's forecasts. Of the large countries, the two PMIs for Germany point to modest growth, even though the PMI for the manufacturing sector is scarcely in positive territory, 50.3 (49.8), whilst that for the services sector is more positive at 54.1 (55.7). But for the number two and number three economies, the outlook is grim. France is deep in negative territory. Its PMI for the manufacturing sector is 43.9 (42.9), whilst that for services is even worse, 42.7 (43.6). The story is scarcely better in Italy, with the manufacturing PMI at 45.8 (47.8) and the services one at 43.9 (45.6).



All this bad news must be put into the context of a currency area whose members have few of the common characteristics necessary for the euro to be a success. If we look at the leader of the eurozone, Germany, we see a country with strong public finances and a large current account surplus. It has taken the hard decisions necessary for it to be competitive and it has been assisted by the euro being a weaker currency than the Deutschmark would have been had EU countries retained their own currency. This is in contrast to what has happened elsewhere in the eurozone. If we look at the next three largest eurozone economies, France, Italy and Spain, we note that they have all suffered a significant loss of competitiveness against Germany since the start of the euro and this is reflected in current account deficits. These have to be financed and a currency union does not protect them from a loss of confidence and rising government bond yields, as we have seen. This is why we do not accept the argument that the eurozone's crisis has gone away and we continue to believe that the eurozone will fragment. As we have often mentioned, the "one size fits all" policy for the eurozone and the inability for a eurozone member to control its own currency are fatal weaknesses, in our view. We mentioned just now, how France, Italy and Spain have lost competitiveness against Germany since the start of the euro. We very much doubt if these countries will regain their competitiveness by accepting measures which amount to an internal devaluation, i.e. cutting costs to restore their competitiveness, which will include wage cuts. It is true that Spain has clawed back some ground, but the cost in terms of unemployment, particularly amongst the young, is very high and we believe that there is a limit to what the electorate will accept. We think the crucial country will be France, where it is now accepted that the growth estimate for this year, originally forecast by the government to be 0.9%, is out of reach and, in turn, this will mean that France will not be able to meet its commitment to reduce its budget deficit target to 3.0% of GDP this year. The latest reports suggest that France is asking for more time to meet its commitment because of the effects that more austerity will have on the French economy. France has its own unique economic model and we do not think that the French electorate, who were not warned in front of last year's election about the actions which would be necessary to restore its public finances, will stand for the measures necessary to put its finances on a sustainable footing. Whilst France, as demonstrated by its bond yields, still enjoys the confidence of the markets, it is not a foregone conclusion that it will continue to do so, particularly if the budget deficit targets keep slipping. The problem is that, given the number of eurozone economies which are expected to contract this year, the austerity measures imposed upon them create a vicious spiral as far as public finances are concerned. So, in our view, nothing fundamental has changed in the eurozone. Mr Draghi's words have certainly been very effective in shaping expectations, but nothing really has changed, and we expect the crisis to reassert itself, either through the markets or social unrest. We have mentioned, earlier, the shocking unemployment levels in Greece and Spain but it is relevant to note that the EC's forecast for eurozone unemployment this year is 12.2% (11.4%). It will be surprising if there is not a further reaction against this arising from the social misery this causes.

Notwithstanding the unpromising outlook for the eurozone, it is important to regard investment in many companies based in the eurozone in a different light. As we can see from the performance of the eurozone equity markets, the poor performance of 2011 was reversed in 2012 and this latest quarter's performance has also been good. There are many world class companies based in the eurozone which look far more interesting investments than their sovereign and the woes of the eurozone should not put investors off the area as far as equities are concerned.

Japan has caused a lot of excitement this quarter as a result of the return to power of the LDP under Mr Abe and the term "Abenomics" has soon entered investors' language. Mr Abe's proposals to get the Japanese economy moving have caused the yen to fall heavily and the equity market to rise strongly. Japan suffers from minimal growth, GDP declined by 0.1% in the fourth quarter of 2012 compared with the third quarter, a declining current account surplus, a huge budget deficit and the largest level of outstanding public debt to GDP of an advanced economy and chronic deflation. Mr Abe is playing for high stakes, no doubt thinking that the chronically bad state of the Japanese economy calls for dramatic measures, albeit ones which carry a high degree of risk. Following his election victory in December, he unveiled a JPY10.3 trillion (US\$112 billion) stimulus package.



He also put pressure on the Bank of Japan to raise its target inflation rate from 1.0% to 2.0% and to be an aggressive buyer of government bonds. With a gross level of outstanding public debt to GDP of around 230%, this carries great risks. The foreign exchange market has reacted quickly by pushing down sharply the yen, although Japan has avoided being called a currency manipulator by the G20. Japan, of course, has great economic strengths including a large amount of overseas assets. On the other hand, the need for more energy imports following the shutdown of almost all of the country's nuclear power stations has pushed the country into a trade deficit whilst the current account surplus has shrunk. Whilst over 90% of the country's outstanding public debt is held internally which reduces the risk of a foreign buyers' strike or a run on government bonds, Mr Abe's plans, including much greater politicisation of the central bank, must be considered high risk. The budget deficit is around 10% of GDP and not many countries could get away with this type of policy without suffering severely in markets. Japan's special circumstances, outlined above, may just enable it to get away with it.

From an equity investor's point of view, this very aggressive economic policy has brought short term rewards as the stock market has soared. Weakness in the yen has a dramatic gearing effect on many manufacturing companies' profit and loss accounts. Japanese exporters have been badly affected by the yen's strength in the past as other Asian countries' companies, such as those in South Korea, have gained ground in them. In a country with traditionally very low bond yields in nominal terms, although enhanced in real terms by deflation, Japanese shares have income attractions, with the dividend yield on the Japanese equity market being approximately double that of the ten year JGB. Japanese equities have promised only to disappoint many times in the past. There are reasons why it may be different this time with valuations, on the face of it, attractive.

News from China, a big influence on stock markets these days, given its position as the world's second largest economy, has been a positive influence for investors as signs have emerged that a slowdown in the rate of increase of economic growth has been reversed. The latest IMF economic forecast suggests growth of 8.2% this year, whilst the newly published EC forecasts, referred to earlier in the context of the eurozone, indicate 8.0% growth, in both cases in excess of last year's 7.8% rate of growth, quite a sharp deceleration on 2011's figure of 9.3%. The latest Purchasing Managers Indices from China are in positive territory, although that for the manufacturing sector only just so. Its latest reading is 50.1 against 50.4 the previous month, whilst that for the services sector is rather stronger at 54.5 against 56.2 the previous month. Inflation remains subdued in China at 2.0%, although a little off its lowest level. The authorities remain very vigilant on inflation because it, especially the food price element, has the potential to cause unrest. In this context, it is interesting to note that China has been quite aggressive in its open market operations to drain cash from the system in response to a sharp growth in credit, which could have inflationary implications. Nevertheless, from the evidence currently available, China looks like exerting a favourable influence on the world economy this year.

In the UK, the main economic news has been the downgrading of the UK's credit rating by Moody's from Aaa to Aa1. This was not unexpected as all three major credit rating agencies had the UK on negative watch. The UK has struggled to bring its deficit under control, hampered by growth forecasts not being achieved, partly because of the eurozone crisis, and partly by stubbornly high inflation which has depressed consumer spending. The deleveraging, public and private, which the UK has to undergo, will cramp growth. The Chancellor had, at the outset of his period of office, set great store by maintaining the UK's triple A rating. Since then, the USA and France have lost their triple A rating, so far without much effect, so the blow may be more psychological than actual. Nevertheless, Moody's decision reflects the very difficult situation in which the UK finds itself and it is noticeable that sentiment towards sterling has changed markedly this year as the currency's trade weighted average has declined sharply. All of the major currencies have issues which could justify weakness, as we said before, and, so far this year, investors have focused on the UK's weak points. Towards the end of February, sterling was affected by an unexpected split in the Monetary Policy Committee of the Bank of England when the Governor and two other members, who wanted to undertake a further £25 billion of quantitative easing, were



outvoted. The thinking behind the weakness in sterling, which this caused, is that money printing threatens to debase the currency and, given how aggressive the UK's quantitative easing policy has been, it indicates how bad the UK's position must be. What the UK needs to do is to grow faster. That should improve tax revenues and put a brake on costs related to unemployment. But QE is likely to have diminishing returns. Somehow, confidence has to be restored, which, amongst other benefits, might get business spending again. At the moment, there are not enough incentives to do so. One thing the Chancellor cannot do, however, is turn on the spending taps and increase borrowing again. Siren voices calling for the government to borrow even more must be ignored, for that would be a certain way to encourage the rating agencies to downgrade the UK's sovereign credit rating below the level to which Moody's has already moved it. With no money to spare, supply side reforms, like cutting back red tape and government imposed burdens on business, together with a more pro business message from the government, might help what is a problem to which there are no easy answers for a coalition government containing a wide range of views where compromise is usually necessary. The latest Purchasing Managers Index for the manufacturing sector stands at 47.9 (50.5), whilst that for the much larger services sector stands at 51.8 (51.5). One bright section of the UK economy, in relative terms, is the employment data, which continue to stand in contrast to the GDP numbers. In the three months to December, employment rose by 154,000. Those in full time employment increased by 197,000 in the previous quarter and by 394,000 over the year. This represented the largest annual increase since 2005. Those in part time employment fell by 43,000 during the quarter. The negative construction on these figures is that firms are holding on to their employees, pending an upturn in business, and therefore productivity has fallen. The positive construction is that there is something wrong with the GDP data. Whatever the reason, the unemployment rate of 7.8% in the UK compares favourably with the woeful level of 11.7% in the eurozone.

As in the eurozone, we can, to a useful degree, separate the fortunes of companies from that of the UK economy by virtue of the wide geographical reach of many UK companies, particularly the larger ones. They are generally performing better than the GDP figures for the UK would suggest and, if sterling's weakness is to persist, this geographical spread will provide a useful currency hedge, with the probability of enhanced earnings and dividend growth to provide some protection against higher inflation levels. UK shares still offer reasonable value and, as elsewhere, stand up favourably against elevated bond prices.

Of necessity, our review has concentrated on the many negative features of the world economy, particularly in relation to the eurozone, Japan and the UK. We live in dangerous economic times. Our belief that the best way to face these difficulties is through holding international equities. This may well seem counterintuitive but the extraordinary monetary conditions brought about as a crisis response to the fallout from the 2007/8 financial crisis are still supportive of equities. A reversal of the very loose monetary conditions will provide a challenge to equities but this seems some way off in the light of very difficult economic conditions. Whilst we expect a modest uplift in equity prices this year, even after a positive start, it will not be without setbacks, given that there will be negative items of news arising from the world's economic difficulties.

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