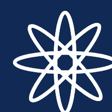

meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

International equity investors, other than those who are U.S. dollar based, have experienced a reasonably positive quarter and many bond investors have done even better. The surreal economic background, highlighted as it is by extraordinarily loose monetary policy, has helped the securities markets to perform well. We have seen periods of sharp volatility but the end result has been mainly positive. In the currency markets, for those who were short of the Swiss Franc, the pain has been extreme, whilst the highlight of the commodity markets has been the collapse in the oil price.

The tables below detail relevant movements in markets :

International Equities 31.10.14 - 30.01.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.6	-4.1	-10.0	-0.1
Finland	+10.6	+6.1	-0.4	+10.6
France	+10.2	+5.7	-0.8	+10.2
Germany	+14.9	+10.3	+3.5	+14.9
Hong Kong, China	+1.2	+7.8	+1.2	+12.4
Italy	+2.8	-1.4	-7.4	+2.8
Japan	+6.5	+8.2	+1.6	+12.8
Netherlands	+12.7	+8.1	+1.5	+12.7
Spain	-0.8	-4.8	-10.6	-0.8
Switzerland	-5.2	+5.7	-0.8	+10.2
UK	+3.6	+3.6	-2.8	+8.0
USA	-0.7	+5.8	-0.7	+10.3
Europe ex UK	+6.3	+5.1	-1.4	+9.5
Asia Pacific ex Japan	+1.2	+1.7	-4.5	+6.0
Asia Pacific	+3.8	+4.9	-1.5	+9.3
Latin America	-10.8	-13.7	-19.0	-10.1
All World All Emerging	-0.9	+1.5	-4.7	+5.8
The World	+1.4	+4.7	-1.7	+9.1

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +9.7%

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

Currency	31.10.14	30.01.15
Sterling	2.24	1.33
US Dollar	2.32	1.66
Yen	0.46	0.28
Germany (Euro)	0.85	0.31

Sterling's performance during the quarter ending 30.01.15 (%)

Currency	Quarter Ending 30.01.15
US Dollar	-6.1
Canadian Dollar	+6.0
Yen	-1.7
Euro	+4.3
Swiss Franc	-10.3
Australian dollar	+6.4

Other currency movements during the quarter ending 30.01.15 (%)

Currency	Quarter Ending 30.01.15
US Dollar/Canadian Dollar	+12.8
US Dollar/Yen	+4.7
US Dollar/Euro	+11.0
Swiss Franc/Euro	+16.2
Euro/Yen	-5.7

Significant Commodities (US dollar terms) 31.10.14 - 30.01.15 (%)

Currency	Quarter Ending 30.01.15
Oil	-38.4
Gold	+4.8

MARKETS

Other than for US dollar based investors, it has been a satisfactory quarter for international equity investors. In local currency terms, the FTSE World Index showed a total return of 1.4%, in sterling terms 4.7%, in US dollar terms -1.7% and in euro terms 9.1%. Looking, firstly, at local currency returns, the best returns have come from the FTSE Japan Index (+6.5%) and the FTSE Europe ex UK Index (+6.3%). Within the latter index there were strong performances from the FTSE Germany Index (+14.9%), the FTSE Netherlands Index (+12.7%) and the FTSE Finland Index (+10.6%). On the other hand, following the decision to allow the Swiss Franc to float, the FTSE Switzerland Index showed a negative return (-5.2%). The FTSE UK Index produced an above average return of +3.6%. The biggest negative contributor to the FTSE World Index in local currency terms was the USA with the FTSE USA Index returning -0.7%. Latin America was noticeably weak with the FTSE Latin America Index showing a return of -10.8%. However, it was a dramatic time for currencies and this changed the returns in sterling terms significantly. The slight recovery in the yen raised the sterling total return on the FTSE Japan Index to +8.2%. The turbulence in currency markets following the unexpected decision of the Swiss National Bank to float the Swiss Franc had only a modest downward effect on the sterling adjusted FTSE Europe ex UK Index with the return falling to +5.1%. The resulting strength of the Swiss Franc provided some offset to the weak euro. The strength of the US dollar meant that a below average return on the FTSE USA Index in local currency terms became an above average return in sterling terms (+5.8%). The weakness of the Australian dollar, meaning that a mildly positive local currency return (+1.6%) on the FTSE Australia Index, became negative in sterling terms (-4.1%). The return on the FTSE Latin American Index in sterling terms worsened to -13.7%.

The extraordinary performance of the bond market continued in the latest quarter. Taking ten year government bond yields as a benchmark, the gross redemption yield on the UK government bond fell by 91 basis points to 1.33%, on the US Treasury bond by 66 basis points to 1.66%, on the Japanese government bond by 18 basis points to 0.28% and on the German government bond by an astonishing 54 basis points to 0.31%.

As we touched upon above, the movements in the currency markets were dramatic, with notable strength in the Swiss Franc and the US dollar. Against the Swiss Franc, sterling fell by 10.3% and against the US dollar by 6.1%. On the other hand, it rose by 6.4% against the Australian dollar, by 6.0% against the Canadian dollar and by 4.3% against the euro. Some of the other cross rates were correspondingly dramatic. The Swiss Franc rose by 16.2% against the euro and the US dollar rose by 12.8% against the Canadian dollar and by 11.0% against the euro.

There were also dramatic moves, as everyone knows, in the commodity markets with oil, as measured by Brent Crude, falling by 38.4% during the quarter. This will be discussed later on in the review. Gold rose by 4.8%.

ECONOMICS

At this current time there is no risk of not being able to find enough content for this memorandum if the definition of subjects of interest includes matters which surprise, threaten or persist beyond the expected. We ended 2014 with a level of concern about a slowdown in China and the prospect of

interest rates moving in different directions in different parts of the world - with both being comment worthy; in January we have seen the IMF, the World Bank and others revise down world growth forecasts, oil - for the time being - reach a plateau below half of its price of last summer, Greece have a general election, the Swiss franc rocket in value and the European Central Bank decide to print at least €1,100,000,000,000. A month is a long time in economics.

It may be worth prefacing this commentary with an observation that has certainly been tested over the past seven years and that is that, if the investor considers all of the threats and potential threats (without being able to factor in unknown threats!) at any time, the temptation would be to never invest in risk assets. The absence of risk is unrealistic and cannot be a pre-condition of investing. Indeed, those who have chosen to remain in the market through the turbulence of the financial crisis and the ensuing and ongoing recovery, are likely to now find themselves in a relatively healthy place; that does not mean that complacency should be allowed to obscure the fact that equities remain a volatile asset class and bonds are susceptible to a market shift if views on future interest rates change quickly. January is a good time to give some thought to how short term returns may be affected and, as we did last year, affirm the Meridian stance which would be to highlight the strong chances of negative quarters in 2015.

There is now a wider consensus that world economic growth in the coming years will be lower than previously thought. Christine Lagarde, Managing Director of the International Monetary Fund, was speaking mid-month and described the growth outlook as “too low, too brittle and too lop-sided” as it revised down its world growth forecast from 3.8% to 3.5%, despite believing cheap oil represents “a shot in the arm”. At the same time it must not be forgotten that this revised rate is close to the average rate over the past 30 years, though it had been hoped that there would be a growth surge to counterbalance the output lost in the recent financial and economic crisis. Similar revisions were also made by the World Bank. 2014 was characterised by increased imbalance in world growth with the broad American market S&P500 growing by 13.7% in dollar terms, the FTSE100 by 0.7% in sterling terms, the DAX (Germany) growing by 2.7% in euros and the Nikkei 225 growing by 7.1% (in yen). The recovery is most fully established in the United States and with a strong recent record of job creation and an economy that is well placed to benefit from cheap local oil. The headwind is that the dollar has strengthened which will reduce the value of non-domestic income to its companies and incentivise importers whose products and services will be discounted by a stronger dollar.

The subject of oil is always emotive, being such an everyday commodity whose price can vary by such large amounts. 10 years ago Brent Crude, a commonly used reference, was around $50 per barrel and rose to an all time high of $146 per barrel in June 2008 before crashing down to $37 per barrel by the end of that year. As the recovery gained traction, oil was back over $100 per barrel from 2011 to 2014 before its most recent crash to its current level just below $50 per barrel. The two schools of thought on what this current level means, as you would expect, suggest contrasting outcomes. More pessimistically, this fall in price is due to a fall in world demand, which goes hand in hand with the global slowdown as oil tends to rise in the good times and fall in the bad. The more optimistic view is that this is a supply issue and in fact the low price will act as a massive subsidy to consumption or investment for the end user, boosting growth.

Our view at Meridian is that this is more an issue of supply where, for various reasons, suppliers have considerations beyond price to continue pumping. Price theory dictates that falling prices are created by a drop in demand or a rise in supply, with the market price dropping to invite both sides to restore the equilibrium. To our minds it is easier to imagine that it is not a drop in demand which

has caused the price to fall by 60% since last July as this implies a significant change in patterns of demand. Rather, we would suggest that it may be a supply side matter, with traits reminiscent of a game of poker or a turf war as traditional suppliers assert their stance in the market in the face of new entrants, particularly the fracking industry in North America and elsewhere. This is a crude over-simplification and there has been some moderation of world growth rates by many analysts and economists, however many oil exporting countries would see it as a successful strategy if reduced revenues in the short term led to reduced future global production capabilities as some market participants fall by the wayside. Current market concerns in this area would probably centre on fears that oil around $50-55 per barrel supports the view that an economic slowdown is upon us, there is an increased credit risk of oil and oil services businesses and, lastly, what the political effect could be on the most vulnerable oil exporters such as Venezuela, Iran and Russia; none of these three examples were enjoying the best economic circumstances before this drop in valuable hard currency exports. It would be easy to write extensively about where an artificially low oil price could lead us but, given the participants and nature of the market, it is not difficult to understand the element of the unknown it brings to the investor's portfolio.

Production in Libya and Tunisia has increased more than expected and production in Iraq has not fallen despite problems there. More important than these is, of course, Saudi Arabia's announced intention to maintain production, despite the steady increases from OPEC and non-OPEC countries and November's announcement that it would maintain its production ceiling of 30m. barrels per day despite the perceived glut. Before this happened there was a perceived floor in the price as traders thought that a price fall would create a response from Saudi Arabia which would cut production in its traditional role of swing producer. This policy change has produced a fundamental change in expectations about the future path of global oil supply, explaining the timing and the magnitude of the fall in oil prices. A similarly dramatic drop occurred in 1986 when Saudi Arabia stopped being the swing producer and oil fell from $27 to $14 per barrel, only to recover 14 years later in 2000.

The International Monetary Fund published a report this month entitled "The 2014 oil price slump: seven key questions" in which it considers the causes and likely effects of the oil price fall. It observes that commodities such as metals are typically more sensitive than oil when global economic growth rates falter and yet that commodity group has suffered more modest falls in price. Using forecasts from the International Energy Agency it concludes that the rate at which oil consumption increases will dwindle but that this is more a supply issue.

The IMF looked at the "financialisation" of oil and other commodities - their becoming asset classes in their own right, believing speculation could cause the drop, bur found little evidence of this. They did find that oil inventories had reached their highest level in two years, suggesting expectations of price increases, not price declines.

How long will this last? This may depend on whether OPEC and, in particular, Saudi Arabia will be willing to cut production in the future. This, in turn, depends on the motives behind its change in strategy and the relative importance of geopolitical and economic factors. One theory is that Saudi has found it too expensive being the swing producer as supply from elsewhere increases. If so, prices will remain low until other OPEC members or Russia agree to cuts. It may be a strategy by OPEC to reduce profits, investment and eventually supply by non-OPEC producers, some of which face much higher costs of extraction. There is some sign of this happening with expensive exploration projects being shelved, reduced in scale or postponed.

A fairly immediate effect of this dramatic fall in the price of oil is the disinflationary effect it has. Energy is a component of the consumer price index (CPI) through petrol, electricity and gas. In the U.K. the price of electricity and gas did not rise in 2014 whereas it had in 2013 and, added to that, petrol prices at the pump in the UK were 25p per litre below their peak in April 2012. This contributed to the fall in the CPI figure to 0.5% for the year to December. This was the joint lowest figure since records began in 1996 and was previously 1.0% in the year to November 2014. The Governor of the Bank of England will be looking for his pen as, when the inflation rate is more than one percentage point away from the target of 2%, he is required to write a letter to the Chancellor to explain. Since the Bank of England's independence in 1997 all fourteen of the various Governors' letters have been written because of an overshoot rather than an undershoot and Mark Carney, the incumbent, said this month that the inflation rate may fall more, before rising again.

Increasingly, the country's economic correspondents are having to make themselves available for the six o'clock news and high on their list of explanations to give to the nation is the word 'deflation'. In economic circles it is a term spoken in hushed tones, as a phenomenon that must be treated with the gravity it deserves and which is to be feared as much, if not more, than high inflation. Whilst price growth remains positive in the UK it is now negative, on average, across the 19 countries that use the euro. It is probably worth outlining briefly the two principal feared effects and what the sensitivities around them are at the present time. Deflation is said to exist when, across the economy of a country, prices are falling on average. For an individual or company where the deflationary psychology has become entrenched, it makes sense to put off as much expenditure as possible if prices will be lower in the future. This has an effect on the speed at which money circulates through the economy and can become self-feeding. The second, and more significant, risk at the present time relates to indebtedness. Deflation leads to a smaller economy overall, measured by a reduction in GDP. Debt is measured as a percentage of GDP and so the position deteriorates when either a country borrows more for the same size of economy, or if the level of debt remains the same but the economy shrinks. Worse still, almost every leading economy of the world continues to run an unsustainable budget deficit, which means that if deflation prevails, then as both indebtedness is increasing and the economy is shrinking, both parts of the equation are going in the wrong direction. In terms of debt repayment, inflation is a tail wind and deflation a head wind. It is easy for markets to be concerned about this phenomenon because the risks are serious, but as yet small, but also because the future, should such unfamiliar conditions prevail, is more difficult to predict.

Whilst the Bank of England finds itself in a moment of stasis, with no current change to monetary policy, this contrasts with the European Central Bank which has seen a need to act again. In the past it has acted decisively to support its banks through liquidity and it has acted decisively to restore confidence to jittery sovereign bond markets. Now it has had to act to address this problem of deflation. 'Will it be effective?' is a difficult question to answer and 'What are the risks associated with it?' is even trickier, given it is being applied across a range of sovereign states who stand to benefit (or not) to differing degrees. The highest concentration of people asking these two questions is in Germany and it would seem that the task of the ECB getting to this point has much more difficult as it has to consider the interests, often conflicting, of the governments of the nineteen governments that form the eurozone. QE needs to achieve two goals: breathe life into the economy in the way QE can and consider the issues around the unsustainable debt position of Greece. As this involves buying government bonds, the two have become inextricably linked.

A significant aspect of the QE programme that was announced on 22nd January is the element of risk-sharing, with German tabloid 'Bild' offering the headline "ECB takes on the billion euro debts

of weak EU states" the day after the announcement. Germany has walked the line between respecting the independence of the central bank and seeking to have its views recognised. Few can claim not to know what Germany's views are, and its reluctance to be the loss absorber is seemingly reflected in the final model. The Netherlands and Finland have also been vocal on this point and growing voter resistance in those and other countries has been steering the direction of their governments.

In the first paragraph we described the general election in Greece as an economic issue. In times far from the present, such an election would not feature in an economic review like this but given its high profile role in the Europe story at present, whatever happens there can have far reaching consequences. So, Greece is back at the heart of European debate, if not quite at the heart of Europe. The debt of many of Europe's countries has risen steeply in value over the past three years and the start point for the increase in appetite for such securities was probably when the President of the European Central Bank, Mario Draghi, pledged to do "whatever it takes" to save the euro in July 2012. It followed that the central bank would underwrite the debts of the peripheral countries of the eurozone with the intended consequence of investor support for such debt driving prices higher and, consequently, yields on such securities down. Greek bonds are now drifting in the opposite direction with the yield on a 10 year Greek bond currently around 10.8%. This contrasts with the ongoing investor support for Spain (whose 10 year bonds yield 1.4%), Italy (1.6%), Portugal (2.6%) and Ireland (1.1%). The market at present is of the view Greece is not going to make it, but the others will.

So, if government debt is to be bought, who bears the risk if there is a default? When the IMF lends to a country it takes the position of senior lender and all other lenders must form a queue behind them in the event of a default. It follows that, if the central bank demands to be excluded from any 'haircut' which has happened in the past, other holders of the same bonds will see the value of their bonds drop as their potential losses are amplified. This raises the yield which is exactly the opposite of what the ECB is trying to achieve. If the central bank does become a risk taker and there is a default then the countries of Europe would have to bear the cost of the default - mutualisation of the default. This is what happened in the first iteration of bond buying which was called the Securities Markets Programme.

In fact the risk sharing part, reflected by the bonds bought directly by the ECB, will only be 20% of the total with the remainder sitting on the balance sheets of the member states' national banks - each country's bank taking on the debt of its own country. This would seem to be a plan which aims to keep Germany happy whilst creating a new buyer for bonds and, in the case of Greece, a new buyer of bonds that nobody else wants to buy. It is possible that there is a degree of smoke and mirrors with this arrangement and it looks like it will work until it doesn't. This time it seems that each country's central bank will be responsible for its own country's losses. Each country would buy as much of its bonds as the ECB orders, though it might be able to choose maturities. The question is, what happens if that country defaults? If a country cannot meet its debts and defaults, its central bank will be sitting on a huge loss. The central bank could be compensated by the country's government by receiving new bonds, though if it had defaulted then the new bonds would be somewhat tainted. This may be more politics than economics as, ultimately, there will be a loss to bear. If a country that defaults feels it needs to leave the eurozone and devalue then the debt in euros will crystallise and as each country holds assets at the European Central Bank that it has exchanged for cash for that country, the ECB will struggle to avoid a loss.

It is difficult to get away from thinking that no matter how hard you try there is no way to rearrange the pieces so that the debt disappears with nobody bearing a loss. It is also difficult to think that the participants will stop trying to find a way as long as politics can crowd out economics.

In the end, the result of the Greek general election was not a surprise and, immediately after, equity markets and bond markets barely reacted, though the euro did continue its fall, reaching around $1.115, a level it has not been at since 2003, before recovering a little. It is instructive to consider what the effects of this Greek election could be. The new administration will feel it has the necessary mandate to pursue its goal and the electorate will seemingly have limited tolerance of compromise - something that Mr Tsipras will be conscious of, as he faces up to the combined forces at the heart of the eurozone. In terms of debt forgiveness it seems difficult to imagine where the centre ground is with the wealthier members of the currency bloc. It is fairly clear that they have a settled view on how much their taxpayers are prepared to lose, in order to make Greece's predicament easier. That figure is extremely close to zero. It is also worth pointing out that Greece's position is on one hand awful - its level of debt is around 175% of GDP, but on the other hand it now runs a primary budget surplus - which means that the government's budget is in surplus if you ignore the cost of servicing debt. Added to this, and because of previous concessions from Europe, Greece's debt costs the country only 2.6% of GDP to service which compares with France whose debt costs around 2.2% of GDP to service. The election result, to the Greeks, is a triumph over what Tsipras calls the "humiliation" of the past five years. Austerity has driven the country to a stronger fiscal position but the human cost of having a quarter of the workforce without work and an economy which is 25% smaller than it was, has been far too much for the country to bear. The most immediate concern is whether something similar could happen elsewhere and European politicians will be very alert to any signs that may signal such a possibility.

The stakes in every country are very high as taxpayers will ultimately pay for these huge outstanding debts. The question is whether they will be Greek taxpayers, taxpayers from other European countries, or some combination of the two. Ex-premier of Sweden, Carl Bildt, summed up one view with his comment on Twitter "Syriza in Greece has won the election by promising that taxpayers in other Euro counties will pay even more to them. Rather daring." Europe's ruling elite, all of whom will face the electorate at the ballot box sooner or later, must be sensitive to the rising significance of 'alternative' political parties biting at their heels, fuelled by such matters. Alternative für Deutschland, Sinn Féin, Podemos, Front National, Freedom Party *(in the Netherlands)* and UKIP - the list goes on, with all increasing their vote beyond the populist core to the point that they can influence the mainstream. All would be emboldened by debt forgiveness for Greece and, in the other heavily indebted countries, the inclination also to default would be very strong. An essential principle of the European Union is that there is free movement of capital and, more fundamentally, that there is a sense of trust between debtor nation and creditor nation within the bloc, it is easy to imagine the E.U. rapidly reaching a point of no return, should we get to this stage. The limits of the principle of mutual co-operation are being explored at the current time, in a way that nobody ever believed would be necessary just a few years ago. Economics will eventually drive politics.

And Alexis Tsipras has wasted little time in reflecting his pre-election pledges in his policy stance. On his third day in office, and following his first cabinet meeting, the Athens stock exchange fell 7.1% and the yield on 10 year Greek bonds rose to around 10% - an impossibly high rate. Tsipras warned that his government would avoid "catastrophic clashes" with creditors but added "We will not continue a policy of subjection either." His government halted the sale of its controlling stake in the Public Power Corporation of Greece, which accounts for around two thirds of the country's

power output, and also halted the privatisation of Greece's main port, Piraeus, which Chinese giant, Cosco, had planned to turn into its new European hub. Greek banks fell by 40% in value as the potential loss of support from the ECB threatened a liquidity squeeze and a run on those banks. The argument may be building for allowing Greece to leave the eurozone.

Markets abhor uncertainty and, in this David and Goliath struggle, David has the potential to unleash a small but significant weapon in throwing the eurozone into uncertainty and upsetting the political order across the continent by threatening to leave or, indeed, leaving. Politically, it would be devastating for the greater project and nobody knows how it would be done nor at what cost. There could also be great deal of interest from other weaker eurozone countries particularly if Greece ended up better off. So far, other countries are not seeing any reduced appetite from markets to buy their bonds though the yield on Greek bonds has risen and there are some immediate issues for the country to deal with. In March it needs to repay a loan to the IMF and this it can do by issuing short-dated treasury bills, which its banks will buy, but in June, it has a larger tranche of debt that is due for repayment to the European Central Bank. As it stands the picture is straightforward - stick to what has been agreed and the lending programme continues. The electorate in the country, however, believes it has voted for something else.

January has been a good reminder of how quickly events can develop and how it can be difficult to foresee the consequential outcomes of announcements and decisions. Oil, deflation, QE and, now, Greece have moved through the spotlight but it may be that Greece remains in it for a little longer. The eurozone has been here before, with an irresistible force seemingly meeting an immovable object, and each time crisis has been averted. At this time there is an irrefutable truth which lies at the centre of the current predicament and that is that Greece cannot afford to pay its debts. It is also clear that the political room to manoeuvre for everyone involved is very limited and, in most cases, reducing. It is interesting to consider that the most exclusive clubs in the world vet entrants very carefully and are quick to expel those that fall short of their standards. Somehow there is more truth in the opposite in the eurozone. Referring back to the first two lines of this paragraph there must be a realistic concern that there could be a sharp deterioration in eurozone relations, which, in extremis, could become the dominant story of 2015.

Greece's relationship with fellow member states of the eurozone is likely to deteriorate markedly, and this represents a new level of risk to certain investors. The investment policy of Meridian has not changed significantly through the various stages of the economic crisis and we would not seek to disinvest from Europe now. As has previously been stated it is possible to have strong companies in a weak economy and weak companies in a strong one. Most companies that Meridian holds on behalf of its clients would have some exposure to Europe and the euro and it should be remembered that non conventional monetary policy has been very positive for risk assets previously; in fact at the time of writing, and in euro terms, the German, French and Italian markets are all up around 8% over the first four weeks of 2015, though the weakening of the euro against the pound has halved that return in sterling terms. Ultimately an investor is buying the future income streams of the business in the currencies that they are earned and Meridian will continue to choose companies based on their diverse income streams, the potential to grow earnings, resilience of their business model, a position of power in their market and management that recognises the importance of the shareholder. In terms of stock selection, these factors would tend to outweigh the significance of a company being domiciled in any particular country.

The yields on bonds (or lack of because some sovereign bonds are showing negative yields) have no appeal for us. They represent a significant risk once monetary policy starts its long journey to

normality, even though we recognise that this may take some time. Although the cost of holding cash, now that we have deflation in some countries and very low inflation in others, is not necessarily as high as it was, holding it is only for the highly risk averse. The world economy is growing and this provides the opportunity for companies to increase their profits and dividends. With interest rates likely to remain at very depressed levels, yields on many shares remain relatively attractive. It is likely to be an uneven move upwards for equities with some negative quarters, given the volume of bad news, but we remain of the view that long term investors will see the best returns by remaining with good quality equities.

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