



meridian
ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equity markets have recovered much of the losses of the first quarter to end up little changed either side of flat so far this year. Investors have been confronted with a lot of potentially difficult news items but, instead of being influenced by them, have concentrated on the quite satisfactory pace of international economic growth. International bond markets, as measured by ten year government bond yields, have generally ended up little changed in spite of volatile conditions at times during the quarter. In the currency markets, the pound was noticeably weak. In commodities, oil performed strongly but gold continues to disappoint.

The tables below detail relevant movements in markets :

International Equities 29.03.18 - 29.06.18

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+9.1	+11.7	+5.1	+10.7
Finland	+7.1	+8.1	+1.7	+7.1
France	+5.7	+6.7	+0.4	+5.7
Germany	+1.7	+2.5	-3.5	+1.7
Hong Kong, China	-1.7	+4.5	-1.7	+3.6
Italy	-1.5	-0.7	-6.5	-1.5
Japan	+1.2	+3.2	-2.8	+3.1
Netherlands	+3.9	+4.8	-1.4	+3.9
Spain	+1.0	+1.8	-4.2	+1.0
Switzerland	+1.4	+3.9	-2.2	+3.0
UK	+9.5	+9.5	+3.1	+8.6
USA	+3.5	+10.0	+3.5	+9.0
All World Europe ex UK	+2.2	+3.3	-2.8	+2.4
All World Asia Pacific ex Japan	-1.1	+2.3	-3.7	+1.4
All World Asia Pacific	-0.2	+2.7	-3.4	+1.8
All World Latin America	-8.1	-12.8	-17.9	-13.5
All World All Emerging Markets	-3.7	-2.4	-8.1	-3.2
All World	+2.8	+6.9	+0.6	+5.9

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +0.2%

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

Currency	29.03.18	29.06.18
Sterling	1.39	1.31
US Dollar	2.75	2.83
Yen	0.01	0.02
Germany (Euro)	0.43	0.26

Sterling's performance during the quarter ending 29.06.18 (%)

Currency	Quarter Ending 29.06.18
US Dollar	-5.9
Canadian Dollar	-4.1
Yen	-2.0
Euro	-1.9
Swiss Franc	-2.4
Australian Dollar	-2.3

Other currency movements during the quarter ending 29.06.18 (%)

Currency	Quarter Ending 29.06.18
US Dollar / Canadian Dollar	+6.0
US Dollar / Yen	+4.1
US Dollar / Euro	+5.3
Swiss Franc / Euro	+1.6
Euro / Yen	-1.1

Significant Commodities (US dollar terms) 29.03.18 - 29.06.18 (%)

Currency	Quarter Ending 29.06.18
Oil	+14.1
Gold	-5.5

MARKETS

Following first quarter weakness, international equity markets have shown a recovery in the second quarter to leave markets little changed on a year to date basis. In local currency terms in the second quarter, the FTSE All World Index showed a total return of 2.8%, in sterling terms 6.9%, in US dollar terms 0.6% and in euro terms 5.9%. Looking at local currency returns first, the stand out markets on the upside were the UK and Australia. The total return on the FTSE UK Index was 9.5% and on the FTSE Australia Index 9.1%. The USA showed a slightly above average return of 3.5%. On the downside, there was noticeable weakness in the FTSE All World Latin American Index which returned -8.1% and the FTSE All World All Emerging Markets Index which returned -3.7%. However, results change considerably when sterling adjusted returns are considered. In total return terms, the FTSE All World Index returned 6.9%. Besides the UK, the outstanding performers were the FTSE Australia Index, which returned 11.7%, and the FTSE USA Index, which returned 10.0%. Negative performances came from the FTSE All World Latin America Index which returned -12.8% and the FTSE All World All Emerging Markets Index which returned -2.4%. Although there was a lot of action in the bond markets, gross redemption yields, as measured by ten year government benchmark bonds, on sterling, US dollar and yen bonds, ended up little changed. The gross redemption yield on the sterling bond fell by 8 basis points to 1.31%, on the US Treasury bond it rose by 8 basis points to 2.83% and on the Japanese Government bond it rose by 1 basis point to 0.02%. Reflecting a flight to quality within the eurozone following developments in Italy, the yield on the German Bund fell by 17 basis points to 0.26%.

In the foreign exchange markets, sterling experienced a weak quarter. Against the US dollar it fell by 5.9%, against the Canadian dollar by 4.1%, against the Swiss Franc by 2.4%, against the Australian dollar by 2.3%, against the yen by 2.0% and against the euro by 1.9%.

In the commodity markets, oil continued to strengthen on supply constraints, rising by 14.1%, but gold performed poorly, falling by 5.5%.

ECONOMICS

This has been a particularly eventful quarter, and not always in a good way, with developments on the trade front and in Italy causing consternation. But there has also been some good news on the North Korean confrontation which seems to have moved to the background, at least for the moment, following the meeting between the US and North Korean leaders in Singapore. Whilst a nuclear conflagration would have been so serious that investors could hardly build it into their investment policy because the consequences would have been so dire, it does shift to one side an issue which was to the forefront earlier this year. However, there is no reason to be complacent because, as we know, the US and North Korean leaders are unpredictable but, so far, so good.

Before we move on to the current economic and political problems and concerns, let us look at the economic background as it was assessed by the OECD in its May 2018 Economic Outlook. It foresaw world economic growth at 3.8% in 2018, slightly higher than 2017's level of 3.7%. For 2019, it foresaw a further slight increase in world growth to 3.9%. Within this aggregate figure, the USA was forecast to show growth of 2.9% in 2018 compared with 2.3% in 2017 and growth of 2.8% for 2019. The eurozone's growth forecast for 2018 was 2.2% against 2.6% in 2017, whilst a slight slowdown was expected in 2019 at 2.1%. Within the eurozone, looking at the four largest economies, Germany's growth rate in both 2018 and 2019 was forecast at 2.1% against 2.5% in 2017. France was expected to grow slightly less at 1.9% in both 2018 and 2019 against 2.3% in 2017 whilst Italy, which we will discuss specifically later, was forecast to grow by 1.4% in 2018 and 1.1% in 2019 against 1.6% in

2017. Spain, the fourth largest eurozone economy, was foreseen to grow by 2.8% in 2018 and 2.4% in 2019 against 3.1% in 2017. Japan, the world's third largest economy, had forecasts of 1.2% growth in both 2018 and 2019 against 1.7% in 2017. For the UK, growth was forecast at 1.4% in 2018 and 1.3% in 2019 against 1.8% in 2017. Moving on to developing countries, China, the world's second largest economy, was seen by the OECD as growing by 6.7% in 2018 and 6.4% in 2019 against 6.9% in 2017. India, with a fiscal year starting in April, was seen as growing by 7.4% in 2018 and 7.5% in 2019 against 6.5% in 2017. Brazil was forecast to grow by 2.0% in 2018 and by 2.8% in 2019 against 1.0% in 2017. Looking at the G20 countries as a group (this comprises Australia, Canada, Germany, France, Italy, Japan, S. Korea, United Kingdom, the USA, Argentina, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, Turkey and the EU which is a full member of the G20, but whose figures are not included in the G20 aggregate) growth for 2018 is forecast at 4.0% and for 2019 at 4.1% against 3.8% in 2017.

On the face of it, these projections are broadly encouraging. Growth is modest but not spectacular. Inflation, although expected to rise, is relatively modest (the OECD foresees around 2.3% for the USA in 2019, 2.0% in Germany, 1.5% in Japan, the latter excluding the impact of the planned consumption tax rise in 2019, and 2.2% in the UK) and economic policy remains relatively easy despite areas of tightening. Interest rates by historical standards remain extraordinarily low and company profits and dividends are rising in many countries. Of course, there are negative aspects of the current economic environment. Despite the better economic picture, unemployment remains far too high in many countries. For example, in the eurozone, the unemployment level is 8.5% although it has been falling steadily and, within that area, the unemployment level is 20.1% in Greece, 15.9% in Spain and 11.2% in Italy. In Brazil, it is 12.9%. In many countries, real wages have been under pressure and have, in some cases, been negative as inflation has been higher than nominal wage increases. There are signs of a pick up in the level of real wage levels and the desired economic position is for real wages to rise as a result of increased productivity but, for a number of reasons which still puzzle economists, productivity growth has been very disappointing. But ten years after the financial and economic crisis, the world economy looks in a much better place than it did in those worrying times when the financial system seemed near to collapse.

For investors, the situation would not seem normal if there were not things to worry about even though stock markets have mostly performed well during the last quarter. Two issues are now at the forefront of investors' minds, a potential trade war and the Italian political situation and the consequences which may flow from it. The trade war rhetoric is moving so fast that it is perhaps not worth putting numbers on the problem but, rather, to consider the economic consequences of it escalating further. It is, at present, on the basis of projected tariffs on a very modest part of trade not considered too serious for the world economy in terms of the reduction in the growth of GDP which may result but, if the tit for tat continues to escalate as has been threatened by President Trump with consequent retaliation from China, the consequences would be significant.

At a time when the media and certain politicians tend to sensationalise every development, and those on trade fall into this category, it is important to look at the facts and ignore the rhetoric. When President Trump said that trade wars are good and easy to win, he was clearly incorrect. Free trade benefits far more people than it disadvantages and tariffs and quotas disadvantage far more people than they benefit. The President appears to believe that it is wrong for the USA to run a substantial trade deficit with any country. This view, which appears to be driving his current trade policy, is incorrect. A country may be running a trade surplus with some countries and a deficit with others depending upon its comparative advantage or disadvantage in the production of the goods or services offered between the two countries. The USA has a comparative advantage in the production of high tech items like aircraft so, for example, Boeing is a major US exporter, but a low cost economy would have an advantage in more commoditised items. Prima facie, the imposition of tariffs on steel and aluminium, quite punitive in the case of steel at 25%, will benefit the US steel industry as its output becomes more competitive and job prospects in the industry improve. This is in line with the President's "America First" policy. But, of course, it is not as simple as this. Those US companies

which use steel or aluminium now have to pay higher prices for their imports, raise their prices and perhaps suffer a fall in demand for their output with possible employment implications in the industry. Consumers who pay the higher prices therefore have less money to spend on other US produced items with implications for US economic activity. Inflation can be expected to rise with possible implications for interest rates. With knock on economic effects on the countries whose exports are subject to tariffs, growth in international trade would slow and, therefore, economic activity, with consequent effects on employment levels.

However, it is important to understand the USA's complaint in terms of the economic theory behind it. It is true that tariffs and quotas are highly undesirable but the USA's complaint essentially surrounds the dumping of goods at uneconomic prices, the transfer of intellectual capital and reciprocal tariffs at higher rates than in the USA. For free trade to work as it should, there has to be a level playing field so that exports are not subsidised by various means. Over production in China has been an issue for some time and the Chinese government is taking measures to deal with this issue. The transfer of intellectual capital seems to be the issue which irks the President most at the moment and this is an issue with substance. Protectionism can take various forms and, in the case of China, if US firms are to be able to have access to Chinese firms involved in technology they have to pass over the technology through their joint venture businesses. The USA is clamping down on Chinese acquisitions of US firms. Ideally, there would be no barriers to foreign investment but, in China, some sectors are closed to foreign investors completely so, again, it is not a level playing field. Two areas in which China has responded relate to allowing foreigners more freedom to acquire certain financial firms and also cutting the tariffs on imported US cars. The President has also targeted the EU, pointing out that the USA imposes a 2.5% tariff on cars imported from the EU whereas the EU imposes a 10% tariff on cars imported from the USA. In this instance, it is difficult to argue with the complaint.

This brief outline of the trade issues now coming to the fore in a very high profile way tries to cut through the high volume of rhetoric from both sides. The loudest rhetoric is coming from President Trump. He clearly has a particular way of doing business but it may be that, emboldened by his success (at the moment) over North Korea, which was achieved by making some very serious threats that most US politicians would not have made, he feels he can replicate this success on trade by upping the threat level on tariffs to achieve his desired ends. We will have to see but, normally, China would not respond to threats but, behind the scenes, there could be some movement. Both sides have some leverage. President Trump thinks that only the USA can win because China runs a huge trade surplus with the USA and, therefore, the USA has far more items on which it can impose tariffs than vice versa. That is true but, on the other hand, China holds a large amount of US government debt so could theoretically de-stabilise the market by selling some of its US Treasury bonds. In practice, that would probably be an own goal because it would reduce the value of its remaining holdings. It may be the markets which achieve some subtle movement from China. As this is written, the Chinese currency, the yuan, has weakened and there must be a concern that its foreign exchange reserves will fall as money leaves the country just as it has done in the recent past and became a source of concern for the Chinese authorities who subsequently clamped down on the movement of capital.

There are issues on all sides in this growing trade dispute. No country wins from a trade war and one must hope that wiser counsels prevail. As this is written, President Trump is very cross with Harley-Davidson, a company targeted for tariffs on US exports because it manufactures in the USA in a state where Donald Trump's "America First" policy resonated with voters. What has Harley-Davidson done to upset the President? It has said that it will move production outside the USA for EU export distribution to avoid the tariffs that the EU has imposed on imported Harley-Davidson motorcycles. Harley-Davidson has acted rationally to protect its business as it says that the EU tariffs would add around US\$2,200 to the cost for each EU customer. In response, President Trump has said that he will tax Harley-Davidson "like never before" if it goes ahead with moving production outside the USA. He said that the company's motorcycles "should never be built in another country". Statements like this are particularly worrying because they fail to understand the economic consequences of imposing tariffs and the effect of the retaliation.

As an investment manager, we have to take a view on how this turns out. Will there be a full scale trade war which will tip the world economy into recession or will common sense prevail and all parties adjust their position to avoid this danger? At the moment, markets are moving in response to day to day news. For example, as this is written, the market has turned round and advanced on news that White House officials had indicated a softer tone towards China. This, of course, can change but one hopes that the enormity of the damage which a trade war could cause will mean participants draw back from the brink. There can be no winner from an escalation of this dispute. We take the view that some compromise will emerge which will not significantly affect economic growth prospects, for instance those projected by the OECD at the beginning of this review.

Some will think that the biggest problem for the eurozone is Brexit but, in fact, it is probably Italy by virtue of it being a member of the single currency, the third largest eurozone economy and highly indebted. The new Italian government comprises two eurosceptic parties, one being broadly right wing and the other broadly left wing, although they do not easily sit in a defined category. However, it is their euroscepticism which defines them most clearly and the Italian government poses a threat to the EU if they follow through with their policies. The Lega Nord represents the most prosperous part of Italy and wants two rates of tax, 15% and 20%, whilst the Five Star Movement, stronger in the south, favours a basic income for the poor, which would be enormously costly. The result of these policies, aimed at stimulating the Italian economy, will be a widening budget deficit. On current policies, the budget deficit is estimated at 2.0% of GDP for 2018, but these policies, if enacted, would expand that figure enormously, blowing a hole in the constraints of the Stability and Growth Pact's 3% limit. With outstanding public debt at over 130% of GDP, the country's debt is dangerously high, and contravening the Stability and Growth Pact would increase the perceived risk of Italian government debt. This would pose a threat to the eurozone and its currency if investors fled from Italian debt. We will be discussing the ECB's monetary policy shortly but, suffice it to say, assuming that the ECB does end its bond purchases in December, the backstop for Italian debt through central bank purchases in the secondary market will go, leaving Italy to market itself as an attractive destination for bond purchases. The threat to Italian bond yields from fiscal indiscipline is clear and also the threat of contagion to other eurozone sovereign bond markets. Further disconcerting investors is the idea put forward in some quarters of an effective parallel currency, the mini-BOT, running alongside the euro which could undermine the latter. The mini-BOTs issued by the Italian Treasury would be non interest bearing tradeable securities which could be used by recipients to buy any goods or services provided by the state. With Italy being the third largest eurozone economy, the advent of a radical government poses a threat to the European project. Aside from the new government's economic policies, it is challenging the EU on its migration policies and, in the process, highlighting the weakness of Angela Merkel in Germany where the immigration issue threatens a split between Mrs Merkel's CDU and its traditional partner, the Bavarian CSU. The euro is fundamental to the EU's continued ever closer union and, because the UK is outside the euro area, the threat of a challenge to the EU's authority from Italy is very serious. In recent weeks, since the establishment of the new Italian government, the focus on Target 2 balances has increased. It may seem an arcane issue but it has the power to cause enormous issues in the eurozone, particularly in Germany. Germany has always prided itself on its prudent finances (for instance this year it is expected to run a budget surplus of over 2% of GDP) and has taken a dim view of other eurozone economies which have allowed their finances to get out of control. At the moment, Italy has Target 2 liabilities, the Bank of Italy's debts to other eurozone central banks, of €465 billion at the end of May. Between April and May, that amount rose by €39 billion reflecting the political uncertainty in Italy. On the other hand, the strongest eurozone country, Germany, was in the opposite position having claims on the system of €956 billion. Should Italy leave the eurozone and revert to, say, the lira, countries like Germany would sustain huge losses. As we have often stated over many years, the eurozone is not an optimal currency zone meaning that the area will be under stress from time to time and could eventually break up because of its internal contradictions. The efforts taken by the EU and ECB to deal with the earlier crises surrounding Greece and other countries would be as nothing compared with what would happen if a crisis blew up in Italy. Although highly eurosceptic, the Italian coalition parties have toned down their rhetoric about leaving

the eurozone, but their proposed policies are a direct challenge to the system. If it led to Italy leaving the euro, it would be a major crisis. Italy is therefore a very important country to watch for investors. In early signs of stress, apart from the build up in Target 2 balances which reflects effectively a capital flight, the gross redemption yield on ten year Italian government bonds has risen to 2.73% at the end of June, a rise of 0.35% over the last month. This compares with 0.26% on the German Bund, the most highly rated country in the eurozone. An interesting and plausible argument advanced by the Daily Telegraph is that this huge Target 2 imbalance actually gives Italy a lot of leverage in negotiating with Brussels about its fiscal policy. This is a variation on the well known saying that if you owe the bank, say, £1,000, you have a problem but if you owe the bank £1 million, it has a problem. It is in this context why one can see that Brexit should be less of a problem for the EU even though the UK is a larger economy than Italy. The euro is critical to the development of the EU and its move to ever closer union. If one of its underpinnings, the common currency, were to be under threat, it could cause the EU to break apart. With populist parties on the rise in a number of EU countries, the EU is facing a difficult challenge and investors need to monitor the Italian situation particularly closely at present.

As opposed to the two issues, the trade friction and Italy, which have come to the fore this latest quarter, the gradual tightening of monetary policy has been an issue for some time ever since the Federal Reserve started the current cycle of interest rate rises, now seven in total. The challenge for the international bond markets is how far along the yield curve short term interest rates rises will have an effect or what the effect will be and, for equities, how they withstand the effect of more competitive interest rates against which to compare dividend yield levels.

We are now moving towards a world of tightening monetary policy. This should be put in context because monetary policy will still remain easy in absolute terms, either measured by the level of interest rates, quantitative easing, where it still exists, or a combination of the two. It is ten years since the financial and economic crisis which led to an extreme monetary policy being followed by central banks and that, broadly, is where we are today, even though the trend to reversing these easy monetary conditions has started. One of the reasons why equities have recovered so well since their low point in March 2009 is that the income from shares was far more attractive than the income which could be obtained from bank deposits or good quality fixed interest securities. Now that situation is starting to be challenged in the USA where the yield on 10 year US Treasury bonds exceeds the dividend yield on the S & P 500 by around 1% and short term US interest rates are close to that dividend yield. That is generally not the case in other major markets where equity dividend yields remain relatively attractive measured against central banks' interest rates, and real central bank interest rates yields are significantly negative in many countries. This would be the case for the USA (if measured by the Consumer Price Index as opposed to the Federal Reserve's favourite measure, the core Personal Consumption Expenditure Index), Canada, Japan, Germany, France, Italy and the UK. In the context of the economic forecasts from the OECD referred to earlier in this review, negative real yields are generally undesirable. Growth is moderate and not low enough to require the sort of stimulus negative real rates might be expected to give to boost it. The undesirable effects surround a misallocation of resources. For example, what are called zombie companies can be kept going because they can service their debt at very low interest rates. Prima facie, that would seem desirable because those companies could maintain employment levels, something which everyone should want. However, it is the effect on other companies which are in a potential expansion position which is adverse. Because there is a competitor remaining in the market which would not be there in normal circumstances, the successful companies' expansion plans, including taking on additional employees, would be limited. That is not good for economic growth because an economy needs dynamic companies to succeed and, as an aside, this might be one cause of the disappointing level of productivity growth in the UK (and elsewhere). Another malign side effect is the distortion caused to investment decisions. For example, many investors are focused on income but, with cash deposits and high quality fixed interest securities offering such low returns, attention has turned to other assets, shares being one and property another. This could lead to asset price bubbles which, when burst, could cause significant collateral damage both to those whose assets have collapsed in value and to banks which have lent money to finance

such assets, particularly property. From a macro economic point of view, it is desirable that, in future, monetary policy can again play its part in providing an economic stimulus, if necessary. With interest rates at present very low levels, monetary policy is pretty well exhausted as a tool of stimulus so it is desirable that interest rates rise to levels from which they can be reduced if necessary to be an effective policy tool. This is why investors need to feel comfortable that they have confidence in interest rate signals being given by central banks. If policy developments are understood, then fewer shocks are likely which should help market stability. Market signalling by central banks has to be carefully calibrated. From our position as an investment manager, taking a long term view, the importance of the normalisation of economic policy, particularly in respect of the monetary side, is self evident. Whilst a very easy monetary policy has provided the catalyst for strong equity investment returns since 2009, it is not a strong support for the long term because of all the distortions to markets and economic policy which is caused. A background, against which equity investors can be comfortable for moderate stepped interest rate increases, is one of satisfactory economic growth at modest inflation levels. Moving towards a neutral interest rate level which is neither stimulative nor restrictive against this background would be a desirable position for long term investors. Since quantitative easing was introduced, central banks' balance sheets have expanded enormously. This is an undesirable position since it could set off an inflationary spiral in future if money started circulating around an economy more quickly leading to excess demand which drives up prices. For investors, it is the trade off between rising interest rates and continued economic growth and the effect which the interaction of these two factors impacts on corporate profits. We do take comfort from the fact that central banks appear fully aware of the need for careful signalling of their intentions, even though there is sometimes uncertainty over the interpretation of their statements.

Furthest down the line in tightening monetary policy is the US Federal Reserve. Not only has it begun a series of interest rate increases but it is embarking upon increasing quantitative tightening in order to reduce the size of its balance sheet by steadily reducing the amounts of maturing asset proceeds which it is reinvesting. Raising interest rates steadily and embarking upon quantitative tightening represents the biggest move to reverse monetary policy of any central bank. Countering the effect of this is the significant fiscal loosening announced at the beginning of the year in the USA where corporate and personal tax cuts will raise the amount that the US federal government has to borrow. However, the second order effect may be to raise interest rates further, certainly out along the yield curve as the US Treasury meets its financing requirements through bond sales. However, with the USA tightening monetary policy faster than elsewhere, money could flow into the US dollar and US Treasury bonds, attracted by higher interest rates arising from the Federal Reserve's tightening policy so it is possible that yields further out along the yield curve will be lower than one would expect given the background of quantitative tightening and higher government borrowing. Further interest rate increases from the Federal Reserve are in the pipeline following its June increase when the Federal Open Market Committee raised the target for the federal funds rate to 1.75% to 2.0%, an increase of 0.25%. This is the seventh time that the FOMC has raised interest rates in the current cycle and the expectation is that there will be two more increases this year on top of the two which have already occurred and three more in 2019 which, if they all occur and take place in 0.25% steps, will put the target rate at 3.0% to 3.25%. The statement accompanying the rise in interest rates was quite hawkish as it mentioned "sustained expansion of economic activity, strong labour market conditions and inflation near the Committee's symmetric 2% objective over the medium term". As we saw at the beginning of this review, the OECD has a robust 2.9% growth forecast for the USA this year and this will have been influenced by the large tax cutting package in the USA. So, against this background, it is no surprise that the Federal Reserve sees the necessity to raise interest rates and to be in the lead in tightening monetary policy. At the same time, US corporate earnings, helped by the corporate tax cuts, have been rising strongly, thus helping to keep the US stock market quite buoyant. This is the level of trade off between monetary policy normalisation and rising corporate earnings that investors would like to see in terms of validating the US stock market's big rise over recent years.

In the eurozone, too, the central bank is beginning to tighten policy, albeit from an extremely loose base. Here, the tightening is not through interest rate increases but through quantitative tightening as the ECB reduces and then plans to stop purchasing assets at the end of the year. At the beginning of the year, the ECB cut the amount of its monthly asset purchases from €60 billion to €30 billion and from October to December the amount will be reduced further to €15 billion before being stopped completely, assuming that conditions do not deteriorate. The ECB signalled, however, that interest rates were not likely to rise before September 2019. However, the difficulty the ECB faces is that it has to pursue a monetary policy which is a best fit for nineteen different countries which are members of the eurozone and, inevitably, it does not fit all of them, especially as eurozone economies have diverged instead of converged as they were supposed to do. We have outlined the threat to the eurozone from the electoral developments in Italy and, in this context, the proposed ending of quantitative easing by the ECB and, therefore, the withdrawal from the market of a big buyer of fixed interest securities, may make it challenging for Italy to sell its government bonds to finance its budget deficit or refinancing existing maturities. If there is a problem for financial markets emanating from Italy, it is quite likely to have a knock on effect within the eurozone bond markets. Even if the ECB was still buying eurozone government bonds after any crisis had erupted, it could not favour Italy because of the capital key rules which relate the size of its purchases in the secondary market effectively to the relative size of its economy and the ECB could not finance Italy's budget deficit by buying new government bond issues. The European markets have underperformed the US ones this year and the latest developments in Italy have undoubtedly frayed some investors' nerves. Germany, for instance, is not a good place if the trade war with the USA escalates because of the profile of its exports to the USA which includes substantial motor car exports. President Trump is fond of reminding the EU, as we noted earlier, that its car exports to the USA suffer a 2.5% tariff but the USA's car exports to the EU suffer a 10% tariff.

Back in the UK, the latest Monetary Policy Committee meeting of the Bank of England caused a mild surprise when the previous 7-2 vote to retain interest rates at 0.5% suddenly became 6-3 when the Bank of England's chief economist, Andy Haldane, changed sides in supporting an interest rate increase. This temporarily caused a rise in the value of the pound on the foreign exchange markets, although it has since fallen back at the quarter end. Although inflation has moved down from its peak levels, interest rates are significantly negative in real terms and, although the economy had a very sluggish first quarter, it is likely to have made a partial recovery in the second quarter. With unemployment at record levels and signs of pay increasing, there is a strong economic argument for raising interest rates. As elsewhere in the world, it is important to build up some monetary ammunition for the next recession. It is possible, therefore, that interest rates will be increased in August. But there was another interesting development. Whilst the Bank of England has not been involved in quantitative easing since it increased the size of its asset purchases in the aftermath of the Brexit vote in 2016, it sits somewhere between the Federal Reserve in the USA and the ECB on the spectrum of monetary policy, but it is setting the scene for a reduction in the size of its balance sheet. The Bank of England had indicated that it would consider cutting the size of its balance sheet when interest rates reached about 2%. Now it says that it could consider doing so with interest rates at 1½%. We consider that the UK fixed interest market is significantly overvalued and it could be vulnerable to the advent of quantitative tightening. There are always investors who have to buy fixed interest securities but, for those who do not, yields look well away from reality. The current inflation rate in the UK is 2.4% yet, at the end of June, we see the five year UK government bond yield at 1.01%, the ten year one at 1.31% and the thirty year one at 1.73%. We find it difficult to contemplate under what circumstances any of these maturities can be considered an attractive investment and quantitative tightening, whenever it comes, is going to present a further challenge.

The only area where quantitative tightening does not seem to be on the horizon is Japan where the government and central bank determinedly pursue their target of around 2% inflation in a country with a deflationary mindset. Quantitative easing has been on a grand scale in Japan with the size of the Bank of Japan's balance sheet about 90% of the size of Japan's GDP. The risks of a bloated central bank balance sheet are the same in Japan as elsewhere. However, with most of Japanese debt

held internally, the risk of a loss of foreign confidence because monetary policy has got out of control is lower than elsewhere. Japan, these days, does not appear on most investors' radar as a high risk market in spite of its unconventional monetary policy which includes official organisations buying large amounts of equity exchange traded funds.

One interesting point to note about fixed interest markets, and one which elicits a lot of comment, is the flatness of the yield curve. For instance, at the end of June, the difference in yields between 2 year US Treasuries and 30 year Treasuries was just 51 basis points and, in the case of UK gilts, 101 basis points. This suggests that investors fear a recession, particularly when very short dated bond yields are artificially being suppressed by extreme monetary policy. This is not necessarily an accurate indicator and it does not feel that way at present unless the trade war escalates out of control but the situation needs watching.

We have obviously discussed China in the context of the current trade dispute with the USA and China is President Trump's prime target. President Trump thinks he can win this battle because of the huge bilateral trade deficit between the two countries favouring China. Last year the USA had a US\$375 billion trade deficit with China. President Trump thinks that China will run out of US imports on which to impose tariffs before the USA does and that, therefore, the USA is in a more powerful position. The issue is much more complicated than this and, as we said earlier, nobody wins from a trade war. China does, however, have vulnerabilities and, at least in the short term, sentiment seems to be turning against it. The Chinese stock market has been weak this year and has notably underperformed. The currency has started to weaken, it is believed, as a result of outflows through the Connect Scheme between the Hong Kong, Shanghai and Shenzhen stock exchanges. The Hong Kong Connect Scheme, initially with the Shanghai stock exchange and now also with Shenzhen, provides a two way opportunity, up to certain limits, for investors to invest in each other's markets. Foreigners could access Chinese "A" shares in this way, those mainly held by domestic Chinese investors. As a result of earlier suspected capital flight, the Chinese authorities clamped down but the Connect arrangement does provide an opportunity for the Chinese to move funds away from China. A weakening Chinese currency will provoke President Trump even more. The transformation of the Chinese economy from one based on fixed asset investment and exports to a more consumption and service orientated one is a difficult one and the Chinese government's attempts to give it technical leadership have resulted in the acrimonious spat with Washington. With President Xi having accumulated enormous power for himself, from an economic and investment standpoint, it is vital that he uses it the right way and that is a question that investors in China have to ask themselves. In the short term, investors have to focus on the trade dispute with the USA and the Chinese currency which may be sending signals about internal confidence in China.

It is worth making a general point about emerging markets. There is a tendency to consider them an homogenous group perhaps especially when the sector has been underperforming developed markets. At a time when US interest rates are rising and the currency strong, moves out of emerging market currencies to the US dollar threaten to tighten monetary conditions in those countries. As a whole, emerging market countries have issued substantial amounts of US dollar debt so concerns rise when the US dollar strengthens. Suffice it to say that each emerging market country needs to be considered in isolation for their strengths and weaknesses.

Finally, we consider the UK. After a poor first quarter, the UK stock market has recovered well in the second quarter, yet there seems to be no particular economic reason for this, more it has to do with strength in the oil and mining sectors. With sterling having been weak over the quarter, the overseas earners will benefit. The two issues which are considered important for the UK market, Brexit and the political uncertainty, are not likely to go away. As we have said before, we regard the second issue as more important for investors. If the divisions within the government on Brexit somehow lead to a general election, despite the Fixed Term Parliament Act making it more difficult, and there is a prospect of a change of government, the stock market and sterling will be vulnerable to a sharp decline. Even if this parliament goes through to 2022, there will still be a long period of uncertainty

unless the political weather improves for the government. This issue is, to our mind, more important than current economic issues. Whilst growth is more modest than in some other countries, it is not a cause of concern and some indicators like the employment figures point to strength in the UK economy. Although the UK is the third largest equity market in the world (if the Chinese domestic market is excluded) it accounts for only about 6% of the world's market capitalisation. Because one's accounting or home currency may be sterling, this should not influence an investor to go heavily overweight in it unless it is very appealing. At the moment, we consider that the UK stock market holds a high degree of risk, hence our substantial weighting in overseas assets in our client portfolios, which, in any case, is standard practice for us as we seek to diversify risk.

Realistically, one must continue to expect bumpy conditions in international equity markets because of the large number of political and economic uncertainties at this time, whether they be tariffs, political developments in Italy and, perhaps, the UK, and a tightening of monetary policy in the USA and the eurozone and, perhaps, the UK. Whilst the media tends to emphasise the negative news, the world economy is performing quite well and the fact that international markets overall are little changed at the end of the first half suggests a balanced view of prospects. We have been emphasising that, after such a long run of mostly quarterly gains, performance from here is bound to be more erratic albeit in an upward trend reflecting moderate economic growth. We re-emphasise this point at the end of a positive quarter. Bonds remain a very expensive asset class in our view.

Meridian Asset Management (C.I.) Limited is regulated by the Jersey Financial Services Commission, under the Financial Services (Jersey) Law 1998, to carry on investment business. "Meridian" refers to Meridian Asset Management (C.I.) Limited. This document is provided for interest only. Any opinion expressed in this document is a matter of judgement at the time of writing and may be subject to change without notice. No representation or warranty, express or implied is made nor responsibility of any kind accepted as to the accuracy, completeness or correctness of the information stated herein or that material facts have been omitted. The information contained in this document is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product or service by Meridian. Various products or services referred to in this document are subject to legal and regulatory requirements in applicable jurisdictions. They may not be available in all jurisdictions. Meridian makes no representations about the suitability of the information published in this document for any purpose. It does not constitute investment advice. No information contained or referred to in this document should be construed as such. A professional adviser should be consulted with respect to your particular situation. The value of investments and the income derived from them may fluctuate and you may not receive back the amount originally invested. Past performance is no guarantee of future performance. Currency movements may also affect the value of investments. The investments and services referred to in this document may not be suitable for all investors.

© Meridian JUNE 2018