meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Despite weakness in May, international equity markets have enjoyed a positive quarter and, for sterling investors, returns have been enhanced by sterling's weakness. Yields on high quality bonds have fallen dramatically and something like US$13 trillion of bonds are on negative yields. In the currency markets, as mentioned above, sterling has been weak on political fears. Gold had a notably strong quarter as its traditional perceived attractions, at least temporarily, came to the fore.

The tables below detail relevant movements in markets :

International Equities 29.03.19 - 28.06.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+7.7	+9.9	+8.7	+5.9
Finland	-0.9	+2.9	+0.5	-0.9
France	+6.1	+10.1	+7.6	+6.1
Germany	+6.4	+10.5	+8.0	+6.4
Hong Kong, China	+0.1	+3.0	+0.6	-0.8
Italy	+2.0	+5.9	+3.5	+2.0
Japan	-2.2	+2.9	+0.5	-0.9
Netherlands	+3.2	+7.1	+4.6	+3.2
Spain	+1.8	+5.7	+3.3	+1.8
Switzerland	+6.6	+6.9	+8.9	+7.4
UK	+3.4	+3.4	+1.0	-0.5
USA	+4.3	+6.8	+4.3	+2.8
All World Europe ex UK	+5.1	+9.2	+6.6	+5.1
All World Asia Pacific ex Japan	+1.1	+3.4	+1.0	-0.5
All World Asia Pacific	-0.2	+3.2	+0.8	-0.6
All World Latin America	+3.3	+7.2	+4.7	+3.2
All World All Emerging Markets	+0.7	+3.8	+1.4	-0.1
All World	+3.4	+6.2	+3.8	+2.3

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.3%

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

Currency	29.03.19	28.06.19
Sterling	0.97	0.79
US Dollar	2.39	1.99
Yen	-0.09	-0.15
Germany (Euro)	-0.17	-0.40

Sterling's performance during the quarter ending 28.06.19 (%)

Currency	Quarter Ending 28.06.19
US Dollar	-2.3
Canadian Dollar	-4.3
Yen	-4.8
Euro	-3.5
Swiss Franc	-4.1
Australian Dollar	-1.1

Other currency movements during the quarter ending 28.06.19 (%)

Currency	Quarter Ending 28.06.19
US Dollar / Canadian Dollar	-2.0
US Dollar / Yen	-2.6
US Dollar / Euro	-1.2
Swiss Franc / Euro	+0.7
Euro / Yen	-1.4

Significant Commodities (US dollar terms) 29.03.19 - 28.06.19 (%)

Currency	Quarter Ending 28.06.19
Oil	-2.7
Gold	+8.3

MARKETS

It has been a solid quarter for international equity markets. In local currency terms, the FTSE All World Index has shown a total return of +3.4%, in sterling terms +6.2%, in US dollar terms +3.8% and in euro terms +2.3%.

Looking at local currency returns first, the only real outlier on the negative side was the FTSE Japan Index which returned -2.2%. On the positive side, the FTSE Australia Index outperformed, returning +7.7%, whilst the FTSE All World Europe ex UK Index returned +5.1%. There was also an above average performance from the USA with the FTSE USA Index returning +4.3%. Looking at sterling adjusted returns, the strength of the yen meant that the FTSE Japan Index moved into positive territory, returning +2.9%. Australia remained the best performer, returning +9.9%, whilst the FTSE Europe ex UK Index was not far behind, returning +9.2%. The UK, whilst providing a good positive return at +3.4%, underperformed the FTSE All World Index's return of +6.2%.

Bonds, too, performed well, a subject we will be discussing in our review. Using ten year government bond yields as a benchmark, the gross redemption yield on the UK gilt fell by 18 basis points to 0.79%, on the US Treasury bond by 40 basis points to 1.99%, on the Japanese Government Bond by 6 basis points to -0.15% and on the German Bund by 23 basis points to -0.40%.

In the currency markets, the political crisis in the UK took its toll on sterling. Against the yen, sterling fell by 4.8%, against the Canadian dollar by 4.3%, against the Swiss Franc by 4.1%, against the euro by 3.5%, against the US dollar by 2.3% and against the Australian dollar by 1.1%.

In the commodity markets, oil was slightly lower with the price of Brent crude falling by 2.7%, but gold, reasserting its traditional role as a store of value in uncertain times and helped by an easier trend in interest rates, broke through its recent ceiling, rising by 8.3%.

ECONOMICS

The issues dominating markets in recent months continue to the fore and these are trade negotiations, mainly between the USA and China, and interest rates. Markets are in the rather unreal position of showing strength at a time when economic and political conditions appear particularly unsettled and hard to read. These issues have dominated our recent reviews and continue to be the key ones, so it is important to discuss them in the context of formulating one's investment policy.

The stand off between the USA and China has become more entrenched, with both sides raising tariffs again. It is worth plotting the course of the tariff escalations. In August and September 2018, the USA put tariffs of 25% on US$50 billion of Chinese imports and 10% on another US$200 billion, whilst China retaliated with tariffs of between 5% and 25% on US$113 billion of imports from the USA at various times during 2018. Now the USA has raised tariffs on the US$250 billion of Chinese imports which already suffered a 10% tariff to 25% all round and started the process of putting tariffs on a further US$325 billion of Chinese imports, although this threat has now been temporarily paused. In June, China imposed a tariff increase to a maximum of 25% on US$60 billion worth of US products.

In President Trump's view, the size of the trade imbalance between the two countries means that the USA is bound to win. It is not as simple as that, because China can retaliate in other ways, for instance by making life more difficult for US companies operating in China with all sorts of rules and regulations to hamper their business. One of the most contentious issues is the US government's move to curb Huawei's ability to sell equipment in the USA and buy parts from US suppliers. President Trump seems to have backtracked slightly, saying on the sidelines of the G20 meeting in Osaka that some restrictions against the firm would be lifted. Elsewhere, the USA has applied since last year a 25% tariff of imports of steel from the EU and 10% on aluminium. The US lifted tariffs on steel and aluminium imports from Canada and Mexico in May removing a key obstacle to passing updates to the North American Free Trade Agreement. Arguments over subsidies for Boeing and Airbus is a further highly contentious issue and so it goes on.

The bottom line of all this is that protectionism is not good news for the world economy. As an investor, one's ideal economic background is one of steady but sustainable economic growth, modest inflation, low but realistic interest rates, low levels of protectionism and political stability. Against such a background, corporate profits and dividends should grow steadily, enabling share prices to show a satisfactory appreciation. That is the theory and, in an ideal world, that is what would happen but, of course, we are not in an ideal world. Yet share prices have been performing quite strongly. Why might this be? Although the first two quarters have been good ones for equities, the final quarter of 2018 was a poor one, and the reason for this was not only the threat of heightened protectionism through US tariffs, particularly against China, but also of higher interest rates. Although the world economy was performing reasonably well, both of these two negative issues were perceived as a threat to economic growth and, therefore, shares. What turned markets around in the first quarter of 2019 and effectively offset the negative performance of the final quarter of 2018 was the Federal Reserve's U-turn on interest rates to the extent that interest rates in the USA are expected to be reduced twice this year. This has pushed Wall Street, as well as other markets, to around record levels. The very simple reason why shares have reacted so well is that the relative yield attraction of shares against fixed interest securities has been heightened. Yet it all seems so simple. Lower than expected current or expected interest rates mean higher share prices, irrespective of economic growth rates or corporate profits increases. Whilst that may be the rationale for share price increases so far this year, it does not make it valid because all it will do is to expand price/earnings ratios to levels which discount a totally unrealistic growth in corporate earnings.

The bull market has been a long one. It started in March 2009, so it has been going over ten years. This does not mean that it will not continue but, at the very least, one must ask questions. The genesis of the recovery in share prices was the aggressive use of monetary policy by central banks. One of the aims of this policy was to raise asset values and this it has done to levels which are now raising political issues, which we will come back to shortly. The economic gains to be obtained by this very loose monetary policy in the early days were important at a time of economic recession. Rising asset values create a positive wealth effect, encouraging more economic activity and also securing collateral for the banking sector. To those who have lived through periods of double digit interest rates, post financial crisis interest rates would literally have been unbelievable. So unbelievable, in fact, that most people thought that the situation would be normalised after a fairly short period. But, here we are, more than ten years later, and the speculation is that they will go even lower or that a federal funds range in the USA of 2.25% to 2.50% could be the peak of the cycle. In the bond market, there are around US$13 trillion of negative yielding issues. The table at the beginning of this review shows that, for the privilege of lending to Germany for ten years, one would have to pay the government 0.4% and, to Japan, 0.15%. In France, a heavily indebted country with a chronic budget deficit, one would have had to pay, at the end of June, 0.007% to lend for ten years. The economic distortions these ultra low or negative interest rates cause are serious and come with consequences. If one looks at borrowers first, it might seem that they can only win because the servicing cost of maturing debt, if and when it is reset, is so low. However, if the asset is a house, for example, the chances are that the price that has had to be paid for it has been inflated by low interest rates. Then, if and when interest rates return to anywhere near normal levels (even though "normal" may be lower than in the past), the servicing cost of the debt may no longer be manageable. As well as causing financial problems for the borrower, the lender could also have a problem as rising interest rates may cause property prices to decline, leading to mortgage losses for the banks. For businesses, ultra low interest rates could lead to "zombie" companies continuing in existence because they can service their debt but cannot afford to expand. These companies might crowd out fast growing and more innovative companies because they hold on to market share but, overall, because the potentially faster growing and financially more successful companies are held back, there is an overall loss to the economy. Low interest rates can also skew investment decisions leading to more marginal investments going ahead which do not stack up when interest rates rise. If we turn to look at the position of those who have money to invest, the temptation to invest outside one's comfort zone or in speculative investments just to earn what would traditionally have been an acceptable interest rate could lead to disastrous outcomes. Whereas such an investor might traditionally have looked to bank deposits or fixed interest securities to provide an acceptable income, that is no longer the case. We mentioned earlier the extraordinary position of the negative yields on German, Japanese and French bonds, amongst others, but it is not much less extraordinary in the UK. As our table at the beginning shows, the gross redemption yield on a ten year UK gilt is 0.79% and, on most bank deposits, one would achieve less. So, for those who rely on their investments for income, this is a seriously unsatisfactory position. The danger is, and we have all read about these scandals in the newspapers, that investors take risks to achieve the level of returns they deem satisfactory and end up with serious losses. The scandals we read and hear about often involve investments offering returns of well above market levels and, of course, if it looks too good to be true, it probably is. The point of all this is that the levels of interest rates which we are currently witnessing create risks for both borrower and lender and cause significant economic distortions. But this is also relevant at the government level. Not only has the private sector piled on debt, so have governments since the financial crisis. Like individuals or businesses, as the cost of servicing debt has fallen with some expensive debt being replaced by cheaper debt when it matures and new debt being available at low cost, the cheap servicing of the debt limits the strain on national budgets because of its low cost. However, as and when interest rates start to rise, the strain on budget deficits will gradually increase and cause concerns in financial markets about the solvency of the sovereign debtors. Economically, rising debt levels can be expected to impact on economic growth because debt servicing costs impose strains on budgets and have a contractionary effect on an economy as fiscal policy has to be tightened to deal with budgetary strains. Ultra low and negative interest rates have obscured the effect of worsening debt to GDP levels in certain countries.

We mentioned the political consequences of the ultra loose monetary policy which has been followed for the last decade. It could be an issue for investors because politics can often be as important or even more important than economics for investors. As we have often discussed, including earlier on in this review, very low interest rates have raised asset prices so that asset rich investors have fared much better than income poor investors whose real incomes have often fallen. Economically, the important issue should be that overall income levels rise but, politically, it is more attractive for some politicians to want to remove some of the wealth added through the effect of ultra low interest rates rather than to make the whole pie greater. Such measures, whilst electorally appealing to many, are likely to have negative economic effects. A good example of this is in the UK when stamp duty on property purchases was dramatically increased at the top level with detrimental effects on parts of the London property market. The law of diminishing returns may well apply here to stamp duty revenues but targeting a particular section of the market can have undesirable side effects. In the case of the UK, which ran a current account deficit amounting to 5.6% of GDP in Q1 2019, it badly needs foreign inflows of capital. So to take measures which deter such investment is poor economics. Investors therefore need to be aware of the political backlash ensuing from very low interest rates and quantitative easing because it might impact on their investment decision making as anti investor policies are instituted.

So the dilemma for investors is whether to go along with the stimulus to international equity markets provided by the current monetary policy being followed or to consider the malign consequences of the economic distortions which it has caused?

In this surreal world of negative or very low interest rates, we can consider the potential advantages and disadvantages of each traditional asset class. Firstly, bonds, where we retain a very negative stance. At the outset, we should recognise that some institutions have to buy fixed interest securities to match their liabilities, almost at whatever the price. For those who don't, fundamental considerations can apply. In the UK, there are no negative yielding bonds, but let us put ourselves in the position of a German investor who is considering investing in a ten year Bund on a negative yield of 0.4%, which means that if this bond is held to redemption there will be a certain loss. What possible reason could an investor have for investing in a security which is certain to show a loss on redemption? The first is the greater fool theory where the investor can hope that someone would be prepared to buy the bonds off the investor at, say, a -0.5% yield and thereby give the investor a profit. That could happen, but is a very dangerous game to play given that the fundamental case for buying on such a negative yield is almost non existent. The fundamental case would be that the investor expected deflation to exist over the life of the bond and that, although there would be a nominal loss, there would be a gain in real terms as the rate of negative inflation would be greater than the negative nominal yield. This looks extremely unlikely to us. At the moment, inflation in Germany is 1.4%, so buying on a -0.4% gross redemption yield gives a significant negative real return now. Also, one needs to remember that the ECB is trying to reach an inflation target which it is missing at the moment so may do more to try to stimulate inflation. The other reason is that investors may have lost trust in banks and feel that the guarantee of, say, the German government is worth paying for. Although the German banking industry has problems at the moment, such a worry is extremely unlikely to come to fruition. A third reason is that the euro breaks up, in which case investing in a country with an undervalued currency, which is the euro as far as Germany is concerned, could make sense depending upon how the break up occurs. Although we have long believed that the euro would break up and there may be some rationale for this argument, we doubt that it is in many investors' minds at present.

The other point to remember about bonds is that, except at the short dated end of the market, any return to more normal levels of yields will involve some nasty losses for investors which will become greater the longer the maturity. Austria has just launched a second tranche of its century bond, maturing in 2117, for a yield of just under 1.2%. One has to ask how this can possibly be a good investment other than in the short term if yields were to move temporarily lower. The advantage of shares, shown in their returns over many years, is that, after a setback, they do eventually recover and move ahead again. With current negative or very low yields on bonds, however, the impairment of values might be permanent. We have a feeling that one of the next scandals in the market may come when investors realise that bonds are not necessarily the safe low volatility vehicle in which they believed that they had invested. If not bonds, and if one considers oneself a very cautious investor, what about cash? Well, it cannot lose value in nominal terms, whereas bonds, of course, can, so that will be a reason for very cautious investors to hold it. Like some bonds, it can have a negative interest rate so that one is paying the bank to hold one's cash but, with bonds as expensive as they are and likely to fall sharply at some stage, cash is likely to lose less in real terms than bonds. There is, of course, an opportunity cost to holding cash. One might do better elsewhere if one is prepared to take some risk, but a cautious investor might be prepared to lose money in real or nominal terms (if the currency is offering a negative interest rate) to avoid a bigger risk. We might also talk about gold here, which has broken out of a long standing trading range during this latest quarter. It has been a disappointing asset to hold and one we have only held very indirectly through gold shares or companies with gold interests and then only to a very limited extent. Its traditional rationale is as a store of value in uncertain times, and current times are definitely uncertain. Without paying any interest there is always that disadvantage but the mood on interest rates has changed and the opportunity cost of holding physical gold has fallen. One has to hold an extreme view of events, as some do, to believe that this should be a major part of any portfolio. This, therefore, leaves us with shares. Their disadvantage is that they can be volatile and an investor has to be comfortable with this characteristic and, as we have seen, this has been a long bull market. But, for long term investors, we believe that shares represent the most attractive asset class. The first reason for saying this is that, unusually, the dividend yield on shares surpasses that on bonds and cash at present in a number of markets and even in the USA, where bonds yield more than shares, the relationship still looks good for shares as their dividends can grow. A second reason is that, notwithstanding current uncertainties, it is unlikely that the world economy will stop growing. It may be at a slower rate than in the past as indebtedness has increased, but it will continue to grow, and corporate earnings and dividends with it. This should keep the trajectory of the share price graph upwards but, naturally, with some setbacks. If the money printing machine seems likely to splutter into action again, which seems possible in the eurozone, then there must be some concern about inflation awakening. A holder of real assets through shares would be best placed to preserve the value of his or her assets and fixed interest holders of conventional bonds probably the worst. We should not be fooled by the fact that inflation has not yet stirred. If the balances that banks have built up at their central banks start to circulate, we could well see a pick up in inflation. The well known saying about time in the market is better than timing the market is very true but, to adhere to that maxim, one has to be certain that one's comfort level can absorb the down cycles in markets which inevitably come. This is where we think we are today, with bonds very unattractive, cash only for the nervous, who accept that they are likely to lose money in real terms, and shares for those long term investors who can accept downturns in the expectation that the upturns will more than outweigh the downturns, as history has shown.

Despite all the concerns detailed at the beginning of this review, the world economy is still growing even though forecasts for growth are being pared back against the uncertainties of the trade conflict. The latest OECD forecast, issued in May, sees world growth this year at 3.2% against 3.5% last year and its forecast for next year is 3.4%. It sees US growth at 2.8% this year, only fractionally below last year's level, and 2.3% in 2020. The main concerns are in a number of the eurozone countries. In Germany, growth is forecast to be just 0.7% this year, well down on last year's level of 1.45%. For 2020, it forecasts German growth of 1.2%. For France, the picture is a little brighter. The OECD sees growth at 1.3% this year against 1.6% last year and it forecasts growth of 1.25% in 2020. The main concern amongst the large eurozone economies is Italy, where it sees effectively no growth this year against 0.7% last year and 0.5% for 2020. In the context of our earlier brief discussion about Italy's debt problem, such low growth forecasts have to be a concern because there would be insufficient growth to prevent the country's debt burden from rising. The brightest spot amongst the larger eurozone economies is Spain, where growth of 2.2% is forecast for this year against 2.6% last year and the forecast for 2020 is 1.9%. The Japanese economy is forecast to grow by 0.7% this year and 0.6% next year against 0.8% in 2018. The forecast for the UK is 1.2% growth this year against 1.4% last year and 1% growth is forecast for 2020. Elsewhere, and important in the context of what we have been discussing earlier, the Chinese economy is expected to slow down to 6.2% growth this year against 6.6% last year and 6% next year. India's growth is expected to accelerate this year to 7.2% from 7.0% last year and the forecast for 2020 is 7.4%. Recent growth figures in India have, however, been disappointing.

We end, as we have done on all recent reviews, by talking about the UK, a market we consider to be very high risk because of the political fallout from Brexit. We mentioned earlier that politics is as important as economics in determining an investor's stance and this is most evident in the UK now. On the international scene, Brexit is not overly important but, from the UK investor's standpoint, it is the most important issue. This is not because of a view about whether Brexit will be good or bad for the UK but because of what it could mean for British politics. If the UK leaves the EU on 31st October without a deal, it is unlikely that the economy will collapse and the sheer relief that the waiting and uncertainty is over might prompt renewed confidence in the UK economy. Who knows what the short term economic effect will be apart from some inevitable disruption? Far more important is what it means for UK politics. Once a new Prime Minister is in place, the Opposition, it seems, plans a no confidence vote in the House of Commons, which it is possible it will win because of some hints from some Conservative remainers that they might vote with the Opposition. Under the Fixed Term Parliament Act, that could trigger a general election under certain circumstances and, if that occurs, there could be a change of government. The current Opposition's policies are very extreme by UK standards and, if it were to be elected or thought likely to be, the UK stock market and currency would be likely to fall even more sharply than the latter has already. This is a risk for our sterling based clients which we are unwilling to take and therefore our investment policy continues to emphasise very significant unhedged overseas exposure. Diversification is important under any circumstances and, in the current political environment in the UK, it is essential. Recent history shows that an unhedged geographically diversified portfolio outperforms a purely UK based one so, in any circumstances, we are heavily invested overseas. Now, this policy is of paramount importance.

In conclusion, whilst it is pleasing to report a satisfyingly positive quarter, we want to emphasise that we must be realistic about future prospects for the market. The strong results which we have seen in recent times in most, but not all, quarters have been achieved against a background of extraordinarily loose orthodox and unorthodox monetary policy and it looks as if we may now see more applied. It is not healthy that, over ten years after the financial crisis, economic growth can seemingly only be maintained in areas like the eurozone, in particular, with these sort of policies. The economic distortions which we mentioned earlier will only get worse. What is encouraging, in a perverse way, for investors is that this is one of the most reluctant bull markets ever and one does not see the euphoria which typically is seen at the top of markets.

Other major asset classes do not appear to us to be at all attractive and, uncertain though the background is, we continue to see equities as our favoured asset class. After such a strong start to the year, there are bound to be setbacks and negative quarterly returns, but the background is not so negative that we are considering reducing our clients' equity content. More than ever, time in the market seems a wiser choice than timing the market and the minimisation of risk, arising from the UK political situation, is of paramount importance to our sterling based clients.