meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Because of the current circumstances, we are producing an abbreviated version of our regular economic review. We hope you will understand why it is necessary to do this with some members of staff working from home and the office unavailable for full use until the emergency is over.

Selected International Equities Indices 31.03.20 - 30.06.20

Total Return Performances (£ terms)	**%**
UK	+9.1
USA	+22.0
All World Europe ex UK	+18.9
Japan	+12.2
Australia	+31.2
All World Asia Pacific ex Japan	+19.8
All World All Emerging Markets	+18.9
All World	+19.8

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +2.6%

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

Currency	31.03.20	30.06.20
Sterling	0.35	0.17
US Dollar	0.67	0.66
Yen	0.00	0.02
Germany (Euro)	-0.47	-0.46

Sterling’s performance during the quarter ending 30.06.20 (%)

Currency	Quarter Ending 30.06.20
US Dollar	N/C
Canadian Dollar	-4.3
Yen	+0.2
Euro	-2.4
Swiss Franc	-2.0
Australian Dollar	-11.6

Significant Commodities (US dollar terms) 31.03.20 - 30.06.20 (%)

Currency	Quarter Ending 30.06.20
Oil	+59.5
Gold	+9.5

ECONOMICS

International stock markets have recovered strongly from their precipitous fall towards the end of February and into March. To many, this will seem puzzling given the persistence of the pandemic and dreadful economic background. To understand what has happened we need to reflect that markets look ahead rather than react to events current at the time. The pandemic came upon us very quickly. Had markets had a crystal ball and been able to foresee the extent of the pandemic in early 2020, the adjustment might have been more gradual but, in the absence of that crystal ball, the adjustment was brutal. However, once the forced sellers were largely removed from the market, those who remained could eventually expect to see share prices making at least a partial recovery. Why would this have been a reasonable expectation? It is trends which are important. The world economy was and remains in a very poor way because of the pandemic, but it was possible to foresee a time when the news on Covid-19 would be less bad, the effect of the massive economic stimuli would be reflected in better economic news, even if from a very depressed level, and a recovery in asset prices as the vast quantitative easing (QE) programmes found their way into elevated asset prices. Although the reasons behind the present economic crisis are quite different to the Global Financial Crisis (GFC) 12 years ago, some of the tools to deal with it are similar, albeit on a much larger scale, and the effect is also similar, albeit telescoped into a much shorter time period. With interest rates negative or very low, it was a reasonable expectation that share prices would recover. This is not to be complacent for many things could go wrong, but it was rational for investors to take this thinking on board and maintain their commitment to equities. This is in no way being complacent and it is worth drawing attention to recent IMF and OECD economic forecasts, tentative though they must be in a fast moving situation.

If we look at the June 2020 World Economic Review from the IMF, its latest forecast suggests a global economic contraction of 4.9% this year, which is 1.9% worse than its April projection. Next year, it projects a recovery with growth at 5.4%, but it says that this would leave growth 6.5% lower than in its pre Covid-19 projections made last January. As one would expect, it qualifies these forecasts because of the level of uncertainty surrounding the course of the pandemic. The IMF expects the effect of the pandemic to be greater for developed countries than for emerging markets and developing economies. It now projects that, against this background of a 4.9% contraction in the world economy this year, Advanced Economies will contract by 5.9% and Emerging Markets and Developing Economies by 3.0%. Breaking these figures down further, firstly within Advanced Economies, it sees the USA contracting by 8.0%, the eurozone by 10.2%, Japan by 5.8%, the UK by 10.2%, Canada by 8.4% and other Advanced Economies by 4.8%. Within the eurozone, Germany is forecast to be the least badly affected, although the emphasis must be on relative rather than absolute performance. Germany's economy is expected to contract by 7.8% this year, whilst France's economy is forecast to contract by 12.5% and that of Italy by 12.8%. At this midpoint stage of 2020, forecasts for 2021 must be very tentative, but the IMF sees the US economy recovering by 4.5%, the eurozone by 6.0%, Japan by 2.4%, the UK by 6.3%, Canada by 4.9% and other Advanced Economies by 4.2%. Within the eurozone, Germany is expected to recover by 6.3%, France by 7.3% and Italy and Spain by 6.3%, the same figure as for the UK. Canada is projected to recover by 4.9%.

Looking at Emerging Markets and Developing Economies, the projections are less bad than for Advanced Economies this year and better than those for next year. Within the figure of -3.0% this year, the IMF sees China growing by 1.0% this year, India contracting by 4.5%, Russia by 6.6%, Brazil by 9.1% and Mexico by 10.5%. Within the recovery of 5.9% projected for next year, China is expected to show the strongest growth at 8.2%, India at 6.0%, Russia at 4.1%, Brazil at 3.6% and Mexico at 3.3%. It must be emphasised again that these projections must be subject to all sorts of caveats given the uncertain course of the pandemic.

In its latest economic outlook, the OECD takes two scenarios, a single hit from Covid-19, or a double hit if it returns in a second wave. If there is a single hit, it forecasts a world economic contraction of 6.0% this year but one of 7.6% if there is a double hit. A single hit for the US economy is projected to mean a 7.3% decline in GDP this year with a recovery of 4.1% next year but, in a double hit environment, the respective figures are -8.4% and 1.9%. For the eurozone, a single hit is expected to result in a contraction of 9.1% in GDP this year and a recovery of 6.5% next year whilst, in a double hit environment, the respective figures are -11.5% and +3.5%. Within the eurozone and amongst the larger countries, France and Italy are expected to be particularly badly hit. In a single hit environment, the French economy is projected to contract by 11.4% this year and recover by 7.7% next year. In a double hit scenario, the respective figures are -14.1% and 5.2%. In Italy, a single hit scenario sees a contraction of 11.3% this year and a recovery of 7.7% next year but, in a double hit situation, the figures are -14.1% and 5.3%. In Japan, a single hit scenario is a contraction of 6.1% this year and a recovery of 2.1% next year and, in a double hit scenario, a contraction of 7.3% this year and a further contraction of -0.5% next year. For the UK, a single hit scenario is projected to mean an economic contraction of 11.5% this year and a recovery of 9.0% next year, whilst a double hit scenario would mean a contraction of 14.0% this year and a recovery of 5.0% next year. As with the IMF forecasts, the OECD's expectation is that emerging markets and developing economies will perform less badly. For China, for example, in a single hit scenario, the OECD sees the economy contracting by 2.6% this year and recovery by 6.8% next year but, in a double hit scenario, the contraction is expected to be 3.7% this year and the recovery 4.5% next year. For India, a single hit scenario is projected to result in an economic contraction of 3.7% this year and a recovery of 7.9% next year. In a double hit scenario, the contraction is projected to be 7.3% this year and recovery 8.1% next year.

With the outlook so unclear about the course of the pandemic and therefore its further economic consequences, these forecasts must be subject to a considerable amount of error. In fact, whether they are right or wrong is of limited importance against the incontrovertible fact that the world is enduring a very severe recession and all of the above forecasts point to that outcome with an enormous amount of lost GDP, much higher unemployment and an enormous increase in public debt, this against a background which, at the beginning of 2020, was pointing to modest but satisfactory economic growth during the year.

Of course, there were major concerns at the beginning of the year, notably the stand off between the USA and China over trade, and the war of words over China has now taken on a new dimension as China moves to assert more authority over Hong Kong and move away from the "one country, two systems" agreement with the UK. The stakes are rising in this battle for economic and political supremacy between the two major superpowers in the world. How this will work out is impossible to tell. Common sense would suggest that both countries realise that they have much to lose by taking this battle to the wire. Tariffs, sanctions and quotas would badly affect US manufacturing companies and the US consumer. The supply chain throughout the world is finely calibrated and any interruptions can have serious consequences for manufacturers in the USA who have been used to "just in time" delivery of supplies to make the final product. Tariffs raise prices, leaving less purchasing power for US consumers. US manufacturers would suffer further efficiency losses. To some extent, the pandemic has weakened this argument but not eliminated it. The pandemic has caused and continues to cause major disruption to supply chains which is making companies think that it might be prudent to have their suppliers nearer to home to minimise future risks. Any loss of efficiency might be balanced with more certainty about supplies for final manufacture. The USA might also consider that China holds a vast amount of US government debt and could possibly destabilise the US Treasury market. So, there are considerable downside risks for the USA if it ratchets up the trade wars with China. However, it is not one way traffic. China's actions over Hong Kong have made the risks more serious for China. Hong Kong is a very important financial conduit for investment into China. For

China and its social cohesion, economic growth is essential to support living standards and support for the Communist party, so any economic sanctions which slow down growth and hit employment prospects is not welcome to the government. The danger is that positions are becoming more entrenched, not helped by the recriminations over the source of Covid-19.

The arguments over China have become entwined with the forthcoming US Presidential and Congressional elections in November. Standing up to China is one of President Trump's strong messages on the campaign trail and he can be expected to drum home the message, especially at a time when he is lagging in the opinion polls. However, it is not in China's nature to back down, so, at this stage, it is difficult to know where this will all end. Even now, however, when China's relations with the USA are at their lowest ebb and with many other countries as well, one has to hope that reason will prevail.

However, what we are on firmer ground in discussing is the unprecedented fiscal and monetary stimuli applied by central banks and governments around the world and this is undoubtedly the reason why share prices have recovered so sharply, at least temporarily. If we look at central banks first, the balance sheet of the Federal Reserve has risen around 70% from the beginning of the year to around US$7 trillion now, the ECB by about 37% to US$7trillion and the Bank of Japan by about 17% to US$6 trillion. This enormous amount of extra liquidity in the system has been finding its way into assets including shares. The correlation between growth in the central banks' balance sheets and the stock market, exemplified by the US market, is striking. Central banks have been buying bonds in the market not strictly to fund governments' fiscal stimuli first hand in the primary market, but, rather, second hand in the secondary market. Central banks are not supposed to finance governments directly in the primary market but many people will see these enormous central banks' asset purchases in the same light. Those who buy government bonds in the primary market can feel confident that they can sell them in the secondary market to their central banks.

So, whilst we can understand the relationship between large increases in the size of central banks' balance sheets and the equity market and justify our view that shares are the preferred long term asset class which makes them worth holding, even during the most severe economic recession in recent time, it does not mean that it is a good quality reason and therefore why one would normally hold them. Those circumstances would very broadly be an economy growing at a good, but not excessive, pace, meaning rising corporate profits and dividends but without a serious threat of excessive inflation inviting the possibility of higher interest rates. At present, we have a situation of severe economic contraction, falling profits and dividends and concerns about deflation. For the moment, the last things on investors' minds are inflation and rising interest rates and one of the factors which keeps shares competitive is their superior yield characteristics compared with good quality bonds and cash.

Investors would do well to keep in mind the serious economic distortions which extreme monetary policy, as currently practised, is causing. One, which we have just touched upon indirectly, is in the savings market. Many investors rely on investment income and only very low amounts, if any, can be achieved from cash deposits or good quality bonds. In some cases, investors are tempted into more risky assets and we all read of stories in the newspapers of investors who have fallen for these "too good to be true" investments. Traditionally, investors may have considered shares to be too risky because of their volatility but, even after the dividend cuts we are now seeing, the yields are superior to those on cash and high quality bonds.

As we often said in these reviews, fixed interest securities are seriously overpriced in any reasonable scenario. If one looks at the yields in the table at the beginning of this review, one cannot expect a portfolio of bonds bought on those yield levels to satisfy any realistic investment objective. It is the policy of central banks to hold down yields but this policy cannot be followed indefinitely. Besides the distortion to price signalling, investment decisions and economic efficiency, they could lead to inflation, unlikely as that may seem now. If the money created is lent by banks and turns over more quickly so that the velocity of circulation rises, inflation can be expected to follow. That this may happen is amplified by the fact that the pandemic caused a supply crisis with governments shutting down vast swathes of their economies to minimise the possibilities of the pandemic taking an even greater hold. Supplies will be restricted in certain goods for some time to come so that if this liquidity finds its way into increased demand, as governments and central banks hope will happen, inflation could increase, even quite sharply. Were that to happen, meaning at current nominal interest rates that real interest rates would be even more negative, the danger would be that inflation would accelerate further. But there is also an opposite danger. If consumers feel uncertain about their personal prospects, they may decide that precautionary saving is a sensible idea so that, rather than spend the money that is being filtered into an economy, they save it, rendering null and void the fiscal measures that the relevant government is taking. Demand does not increase so economic activity remains sluggish, meaning that government finances remain compromised, and moving an economy into a vicious circle of decline. It may seem that because central banks can control and keep down interest rates, vastly increased borrowing can occur with impunity, but that is not the case. If money printing proves to be too successful in the sense that inflation follows, interest rates may have to be raised which would subdue economic activity and cause serious problems in the bond markets. If people lack confidence in their economic prospects and build up their savings (the savings ratio has risen sharply during the lockdown), then that can derail a recovery, affect the national budget and keep unemployment high. Whilst vast quantitative easing programmes can indirectly finance the budget deficits currently being run around the world it cannot continue indefinitely. Investors will not be willing to finance the deficits indefinitely. In normal circumstances, an increased supply of government bonds would raise interest rates in response to investors' demands, placing some disciplines on governments. We are in danger of getting to a stage when these mind blowing figures for quantitative easing and fiscal stimuli cease to be meaningful and an expectation develops that there is an unlimited supply of money available or to be borrowed.

Relating this back to our investment policy, whilst we understand why bond yields are where they are, we have tried to show why, in different circumstances, they offer no value at the minuscule yields on offer. For the foreseeable future, but not indefinitely, interest rates will remain very low, giving equities the edge on yield grounds. If inflation does become a problem for the reason mentioned, then it would seem advisable to hold a stake in real assets, i.e. shares. We will not dwell on the issue in this review, but one of the major ones for the future is the explosion in public debt throughout the world and what this means for the future.

With corporate earnings falling and international equity markets having shown a strong recovery in the second quarter, it means that many valuations are looking stretched on a conventional basis. Whilst recognising this, we have to consider, as we have mentioned earlier, any attractions which competing assets might hold. Given that investors' main investment objectives will be to increase, over time, the real value of their portfolios, one can confidently say that fixed interest securities cannot do this and that, furthermore, any reversion to mean in yields will involve significant falls in the value of fixed interest securities which will be greater the longer the maturities. Here, we emphasise that this is the longer term outlook because, in these extraordinary times, it is possible to make money on bonds on a short term basis, even against a fundamentally very overvalued background, but it is a risky strategy. Similarly, whilst cash will not lose one money in nominal terms at these levels of returns, even if they are slightly positive in some countries, it can only be a short term asset if an investor is looking to grow a portfolio in real terms over time. Whilst gold is not a mainstream asset for us, if inflation does become a problem later on for the reasons given earlier in this review, one can see an attraction and recently it has benefited from its attraction as a store of value in uncertain times. Set against this is the lack of income and long periods of uninspiring performance. Property, long a favourite for some investors, is facing huge challenges in parts of the market such as retail and some commercial. What this boils down to as far as we are concerned is that equities remain the asset class most likely to meet investors' aspirations over the long term.

In this very uncertain environment, it is of vital importance for investors to stay with quality companies and to diversify their portfolios geographically. This has always been our policy and is an important way of managing risk. For sterling based investors one of the drags on performance over many years has been the danger of “home bias”. It is always tempting to invest in names that one knows best because they are from the home country but, certainly as far as sterling based investors are concerned, it has been an expensive bias. Three months is not a meaningful period of time to judge this issue but it is worth noting that, whilst the UK market made a useful recovery over the quarter, other markets did far better and, over the years, home bias has led to a loss of relative performance. A major reason for the recent underperformance of the UK market is its profile with a lot of value stocks which have remained out of favour, whilst the US market, for example, has been driven by growth stocks. Although growth has outperformed value for a long time now, in a more confident environment attention might turn back to unloved sectors in the UK market and elsewhere. Good companies do not become bad companies overnight but they can be in sectors which are deeply out of favour. In these circumstances, a foot in both camps is a sensible strategy in our opinion so that one is prepared for a change in market leadership.

The enormous health, economic and political uncertainties which dominate the scene at the moment make day to day movements in markets very difficult to call. Although volatility is not nearly as great as it was back in March, 2% or 3% daily moves are still not uncommon. However, as we emphasised in our special memorandum in early March and the March month end review, it is important to consider the measures central banks and governments will take to try to support their economies and we have seen the effect which these have had on share prices in the last quarter. So, our view remains the same. For long term investors, a geographically diversified portfolio of high quality international investments remains the best way to achieve one’s investment objectives even if the short term provides a bumpy ride because of the current health, economic and political uncertainties.