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Investment Memorandum

International equity markets have demonstrated a firmer trend this quarter after initial setbacks arising from concern over the Greek debt situation. Amongst the mostly negative economic indicators, there have been some better signs, and corporate earnings news has generally helped equities. International bond markets, as measured by top quality ten year government bond yields, have trended higher. In currency markets, sterling and the euro, the latter affected by the Greek debt crisis, have been notably weak during the quarter.

The tables below detail relevant movements in markets:

International Equities 31.12.09 - 31.03.10

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+1.8	+10.6	+3.9	+10.2
Finland	+19.6	+20.0	+12.8	+19.6
France	+1.9	+2.3	-3.9	+1.9
Germany	+3.4	+3.8	-2.5	+3.4
Hong Kong, China	+2.2	+8.7	+2.1	+8.3
Italy	-1.9	-1.5	-7.5	-1.9
Japan	+8.8	+15.4	+8.4	+15.0
Netherlands	+4.5	+4.9	-1.5	+4.5
Spain	-9.7	-9.4	-14.9	-9.7
Switzerland	+6.4	+11.2	+4.5	+10.8
UK	+6.0	+6.0	-0.4	+5.6
USA	+5.6	+12.4	+5.6	+11.9
Europe ex UK	+2.5	+4.0	-2.3	+3.6
Asia Pacific ex Japan	+0.6	+8.7	+2.1	+8.3
Asia Pacific	+4.4	+11.8	+5.0	+11.4
Latin America	+2.6	+8.7	+2.1	+8.3
All World All Emerging	+1.8	+9.1	+2.5	+8.7
The World	+4.5	+9.9	+3.2	+9.4

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +1.1%

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

Currency	31.12.09	31.03.10
Sterling	4.01	3.95
US Dollar	3.84	3.84
Yen	1.29	1.41
Germany (Euro)	3.40	3.09



Sterling's performance during the quarter ending 31.03.10 (%)

Currency	Quarter Ending 31.03.10
US Dollar	-5.9
Canadian Dollar	-8.7
Yen	-5.6
Euro	-0.4
Swiss Franc	-4.4
Australian dollar	-8.0

Other currency movements during the quarter ending 31.03.10 (%)

Other Currency	Quarter Ending 31.03.10
US Dollar/Canadian Dollar	-2.9
US Dollar/Yen	+0.3
US Dollar/Euro	+5.9
Swiss Franc/Euro	+4.2
Euro/Yen	-5.3

Significant Commodities (US dollar terms) 31.12.09 - 31.03.10 (%)

Significant Commodities	30.10.09 – 29.01.10
Oil	+6.0
Gold	+1.8

Markets

Despite the poor economic background, international equity markets overall have continued their progress. In local currency terms, the total return on the FTSE World Index for the first quarter of 2010 was 4.5%, in sterling terms 9.9%, in US dollar terms 3.2% and in euro terms 9.4%. In local currency terms, Japan was the outstanding market with the FTSE Japanese Index returning 8.8%. The UK and USA also performed well, with the FTSE UK Index returning 6.0% and the FTSE USA index returning 5.6%. The FTSE Europe ex UK returned a subdued but satisfactory 2.5% with Switzerland performing well with a return of 6.4% and Finland with 19.6%, but Spain, reflecting its economic difficulties, returned -9.7%. Latin America and emerging markets, so often outstanding performers in recent times, were subdued with their respective FTSE returns being 2.6% and 1.8%. However, for sterling and euro based investors, returns were greatly enhanced by their respective currency's weakness. In sterling terms, the Japanese market stood out with a return of 15.4%, the USA with a return of 12.4% and, in Europe, Switzerland with 11.2%. Australia was also outstanding with a return of 10.6% compared with just 1.8% in local currency terms. The return on the FTSE Latin American Index rose to 8.7% in sterling terms and the FTSE All World All Emerging Markets Index to 9.1% in sterling terms.

In the top quality international ten year government bond markets, there was little change in sterling and US bond yields, but German bond yields fell sharply by 31 basis points to 3.09%, reflecting the attraction of the eurozone's best credit against some of the weaker members, notably Greece.

Sterling and the euro performed badly in currency markets with sterling faring marginally worse. Against the US dollar, sterling fell by 5.9%, against the Canadian dollar by 8.7%, against the yen by 5.6%, against the Swiss Franc by 4.4%, against the Australian dollar by 8.0% and against the euro by 0.4%.

In the commodity markets, oil rose by 6.0% and gold by 1.8%.



Economics

At the end of the first quarter of 2010, the state of the world economy is becoming clearer and the problems better known. In some respects, this is good news for investors because fear of the unknown is a negative influence on markets and, if investors believe there are hidden problems lurking, they will have a more negative attitude to markets. Conversely, if the economic background is bad, as it is at present, the belief that most of the bad news is known, even if the issues are not resolved, can be helpful to sentiment and this is, we believe, the case now.

Since the international equity markets started to recover just over a year ago, we have often written about the paradox of equity markets staging one of their largest ever recoveries at the same time as the world economy remains in a parlous condition and worries persist about elements of the financial system. It is a fact that the stock market cycle does not move in tandem with the economic cycle yet, for many people, the performance of the international equity market has been baffling, given the seriousness of the economic situation. We believe, however, that there are sound reasons for what has happened in markets and this includes the other side of the coin, the weakness in international government bond markets over the period of the equity markets' recovery.

Nevertheless, if we look back just one year to early March 2009, one can understand why many investors were lacking confidence. The first quarter witnessed a serious recession and there were unresolved concerns about the financial system. It was, for some people, too early to take a view on how effective the economic measures taken would prove to be and whether measures to shore up the banking system would work. With hindsight, it is always easy to be wise after the event. Nevertheless, it is clear now that the concerns were overdone and shares oversold and bonds overbought, even against a very dangerous economic background which has only improved to a degree.

How can we, therefore, rationalise the movement in international equity markets during the last year? Relief that ways had been found of supporting the international banking system and troubled banks was important. If concerns of a failure of the international banking system had been alleviated, it removed a major fear from the market. The methods by which governments and central banks sought to avoid recessions becoming depressions have helped the stock markets. In terms of monetary policy, very low interest rates and, where enacted, quantitative easing (which we may broadly define as printing money) have helped, as intended, to raise asset prices. Plentiful amounts of money at very low interest rates have caused a distortion in markets as investors have shifted money from very low yielding bank deposits to assets with a reasonable yield such as shares, bonds and property. In the case of shares, this has driven prices higher and that has been the case with certain parts of the property market as well. In the case of bonds, at a time of very heavy issuance, the effect has been to keep bond yields below what they would otherwise have been. For instance, in the UK, the most aggressive country with regard to the relative extent of quantitative easing, it is estimated that quantitative easing has resulted in gilt yields being lower by around 1%, whilst investment grade corporate bonds have seen their yields fall by almost 4% (source: speech by Mr. Charles Bean, Deputy Governor for Monetary Policy at the Bank of England on 16th March 2010). For example, the yield on the ten year UK gilt on 31st March 2009 was just 3.13%. One year later, it is 3.95%, whereas, in the absence of quantitative easing, it would have been higher. But the benefit to equity holders and some property owners and investors in the boost to prices is to give a positive wealth effect which would encourage spending and deliver a positive multiplier effect to the economy. Whilst this very loose and unorthodox monetary policy helped to boost asset prices, it has not stimulated lending overall, as borrowers have attempted to deleverage over extended positions. The paying down of debt, whilst desirable for individuals and companies, if they are over-borrowed, does nothing to stimulate an economy, so banks, awash with cash, have not found ready borrowers, partly because they have tightened their lending criteria. Extremely loose monetary policy, such as we have described above, distorts asset markets and risks creating a bubble. In the case of bonds, we believe that this is already happening.



The second aspect of economic policy, fiscal policy, is also extremely loose, as governments have let budget deficits balloon in the face of the economic downturn. Deficits come in two parts, cyclical and structural. It is reasonable to run a cyclical deficit in tough times as long as a corresponding surplus is run in good times. In other words, governments put aside money in good times to see them through bad times. Unfortunately, many countries have run up structural deficits, which are those which are built into an economy and will not go away in good times, because there is a chronic excess of expenditure over income whatever the circumstances. Governments around the world opted not to try to reduce deficits in 2009 on the basis that the resulting public spending cuts and/or tax increases would cause economies to contract. Insofar as the world economy has avoided a depression, running a very loose monetary and fiscal policy has worked, albeit at a tremendous cost which will have to be paid for.

In the short term, this has meant a better economic performance for the world economy after a very bad 2009 and, in terms of the equity market, investors can look forward to some profit and dividend recovery. So the combination of recovery from an oversold position, once it became clear that the very worst scenario of a collapse in the banking system was not going to occur, cheap and plentiful money looking for a better return than on cash and the prospect of some economic recovery has given an impetus to share prices. Combined with reasonable valuations, even against such a grim economic background, some recovery in shares was validated last year.

Less risk aversion also meant that corporate bond spreads over top rated government bonds narrowed, providing some excellent returns in that market. As we mentioned earlier, government bond yields, as measured by ten year government bond yields, have risen sharply over the past twelve months and of those detailed in the table at the beginning of this review, the rises in US and UK bond yields have been the most noticeable. During the worst of the financial crisis, “safe” assets such as Treasury Bills and government bonds attracted investors, driving yields down to unrealistically low levels. As the level of risk aversion has eased, yields on top quality government bonds have risen although, as we will argue later, not far enough in our opinion.

The contrast between what has happened in stock markets and what is happening in the real economy could not be more stark and this contrast is likely to become even more pronounced as the measures necessary to correct the huge budget imbalances around the world are unfolded. In certain countries, years of austerity will be endured as public finances have to be put in order. Allowing things to go on as they are is not an option. The example of Greece is a case in point. Its level of current budget deficit and overall level of debt as a percentage of GDP meant that it has had, at certain stages, to pay well over double the rate of interest of the eurozone’s best credit, Germany. The corresponding effect of higher interest costs and outstanding level of debt would be such as to make debt refinancing and new borrowing impossible, leading to default and severe economic depression for the countries involved. Greece’s plight was worsened by the fact that it was a member of the eurozone and could not devalue so the decline in its competitiveness since it joined the euro was not able to be ameliorated. As this is written, it looks as if some sort of solution involving the IMF has been agreed but the price which Greece will have to pay for its past fiscal profligacy will be very high. Other countries in the eurozone with high deficits, such as Ireland, Spain and Portugal, have or are taking tough measures all of which will lead to economic hardship and impose contractionary pressure upon their economies. Ireland was one of the first countries to take the painful measures necessary as a first step to putting its finances in order and all involve people’s standard of living being cut. Whilst there have been protests in Ireland, including strikes, they have not been on the same level as in Greece and one can expect social unrest to be seen in Southern Europe. The scale of the adjustment needed will be one which most people have not experienced in their lifetime with significant cuts in real wages and increasing unemployment.

This might not seem a promising prospect for stock markets but there are two positive points to consider. The bond markets of the affected countries, if the relevant country is considered to be a better credit risk as a result of the remedial action being taken, could show a relative improvement which would, at the very least, not be a negative for its stock market. Secondly, banks, which held a substantial amount of sovereign debt, would be less at risk and that would be positive because further concerns about banks could set off more problems in the stock markets.



Whether it is from a position of relative strength (like Germany) or weakness (like Greece) fiscal tightening is going to have to be the order of the day almost everywhere and it is going to constrain growth because the necessary action is going to require cuts in public expenditure and/or tax rises. There is one mitigating factor for the countries affected, mostly European ones, the USA and Japan, and this is that countries in Asia, particularly, of course, China and parts of the Middle East are performing much better and will provide export opportunities to break out of the sluggish growth prospects for the heavily indebted countries. Furthermore, many companies in the heavily indebted countries have substantial business interests in the faster growing economies of the world. This phenomenon provides investors with the opportunity to “break out” of their perhaps rather unpromising home environment.

In our view, bond markets face an enormous challenge. As we mentioned earlier, they had been helped during the eye of the financial crisis by investors’ heightened risk aversion which made some investors buy “safe” assets at any price, i.e. government guaranteed ones. Now, given investors’ lessened risk aversion, that artificial demand has been reduced and we see rises in bond yields as we note from the table. Rates at the very short end are little changed because in most countries interest rates have remained at negligible levels. The very large budget deficits being run in many countries mean very large issuance and current yields generally look inadequate in the face of such huge supply. Secondly, there seems to us to be too much complacency about inflation. It is true that in most countries, inflation is at a low level and that the output gap is quite wide (i.e. the difference between the potential output of an economy and its actual output). However, productive capacity will have been lost in the recession and there are cost push forces to drive inflation higher from commodity prices, for example, which have been moving higher again since their recent low point at the beginning of 2009. Growth in Asia, China in particular, is likely to be a force in propelling commodity prices higher. So, it is not a given that present meagre levels of economic growth will not be followed by inflation and, for those countries with weak currencies, like the UK, the inflationary effect of US dollar priced commodities will be exacerbated.

The main inflation danger is in countries like the USA and UK which have used forms of quantitative easing. In the UK, the most aggressive user of this tool of monetary stimulus, quantitative easing amounted to £200 billion in the financial year to 5 April 2010, very roughly equivalent to the amount of new gilt issuance. Now that quantitative easing has ended, or at least paused, since it may be resumed again, a big buyer of gilts (for it was almost totally used for the Bank of England to buy gilts) has exited the market and this may be expected to push up gilt edged yields. In the USA, the Federal Reserve, at the end of March, has stopped its bond purchasing programme, so the same influences will apply as in the UK.

Of course, it would be very tempting to say that, because quantitative easing appears to have been successful in keeping interest rates in the bond market below what they would otherwise have been, the central banks should continue with the programme. Just printing money to finance deficits seems superficially attractive, particularly at a time of low inflation but, of course, the risks are enormous. The two central banks’ balance sheets have increased in size enormously and the risks from printing money, effectively what this is, arise from its potential inflationary consequences and debasement of the currency. So, whilst, as an emergency measure, it might help in the short term, and probably has, further out it has the potential to cause substantial dangers for the economies in which it has been implemented unless reversed. The timing of the reversal is a very delicate issue - done too soon and it may exacerbate the weakness in the economy and done too late and it may let the inflationary genie out of the bottle and cause the currency to fall heavily. Reversing quantitative easing at its most basic involves selling back to the private sector the assets which it has purchased, i.e. bonds. That, of itself, will create upward pressure on yields and that at a time when governments are borrowing very heavily. This is why we think that there is an air of unreality in bond markets with yields not reflecting the risks involved. Even where quantitative easing has not been used, most governments are borrowing heavily, itself a force for upward pressure on yields.



With sluggish economic growth in most countries, it remains the case that short term interest rates are likely to remain low to offset fiscal tightening, so we are likely to see loose monetary policy combined with increasingly restrictive fiscal policy. Although increased taxes and cuts in public spending are likely to dampen down inflationary forces as consumers' real incomes fall in many cases, very low interest rates, especially if they are negative in real terms, could have the opposite effect in causing inflation and, in normal circumstances, would do.

If one takes the example of Greece and Ireland, their problems and solutions to them are a foretaste of what is to come in other heavily indebted countries. There still seems to be an air of unreality pervading many countries with regard to their debt problems and one has the feeling that many people are not prepared for the severity of measures which will have to be introduced to rectify the public finances of the worst offenders. Pay cuts, public sector job cuts, longer working lives, changed pension benefits, greater pension contributions and severe public spending cuts, not to mention tax rises, are on the agenda. Greece and Ireland have already experienced some of these measures and other countries will have to follow suit.

Membership of the eurozone has exacerbated the problems for these two countries and Spain and Portugal and, perhaps, Italy will also have to address the issues (Spain and Portugal already are to some degree). The normal short term palliative of devaluation is not available to these countries, being part of a monetary union, so they will have to address their lack of competitiveness by reducing relative labour costs. That will be extremely painful and is likely to lead to social unrest. At some stage, there was always going to be a problem for the eurozone because of the big differences in so many ways, but mainly economic, between its various members. Now the crisis with Greece has come to a head the fault lines have been revealed both politically and economically. Politically, it was an embarrassment for some eurozone countries for the IMF to become involved in a eurozone issue but the hard line German stance plus the lack of a bail out mechanism made the involvement of the IMF inevitable if only under a joint arrangement with other eurozone members. The IMF's experience in providing support to troubled countries was an obvious benefit even though proponents of monetary union have found it embarrassing.

Economically, there are a number of challenges. Some critics say that the big trade surpluses of Germany and the Netherlands are to blame for the problems elsewhere. Critics say that, if these governments can get consumers in these countries to spend and thus increase demand and reduce their trade surpluses, it will help to reduce imbalances within the sector. This, of course, assumes that the extra spending will largely benefit deficit eurozone countries which is difficult to believe. Even if the German and Dutch governments felt it to be desirable, they could not easily change the mindset of consumers which is cautious. That remedy is, we believe, a non starter.

In normal circumstances, if the IMF took control when a country ran into financial difficulty, devaluation would be likely to be one of its policy tools to help a country regain some competitiveness. Whilst Greece and any of the other eurozone countries which have problems remain in the currency union that is obviously not an option. But, increasingly, the question is being asked as to whether the eurozone can remain intact because the remaining policy tools required to restore competitiveness will involve extreme pain and that is over and above the measures needed to reduce the budget deficits, with the deflationary consequences of both actions contributing to increased competitiveness. This, however, makes all sorts of assumptions about what will happen to relative costs in countries like Germany and the Netherlands. Such is the level of economic pain that will be necessary to rectify the financial and competitive situation of these countries, that one wonders in a democracy whether the voters will wear this without serious industrial unrest.

So, how might this impact on eurozone stock markets which, despite this unpromising background, have mostly continued to rise during the quarter like other markets even if not to the same extent? The positive factor going for many large European companies is that they have exposure to faster growing parts of the world economy, such as Asia, which helps to limit the effects of sluggish domestic growth. The negative factor is that, if Greece or any other eurozone countries were to default on their debt, European banks' significant exposure would spook the stock market and perhaps require more government action to support the banking system.



The sharp widening of the spread on Greek government bonds over German bonds since the onset of the Greek debt crisis shows that, notwithstanding Germany's status as the best eurozone credit, there was insufficient distinction by investors between the various credits because of being part of a monetary union - in other words, a euro was a euro whichever country was behind the particular euro in question. The Greek crisis and widening bond yield spreads elsewhere within the eurozone show that not now to be the case.

There is nothing that many politicians enjoy more than spending other people's money and, for a long time, many got away with it but, at the end of the day, bond markets and/or foreign exchange markets will catch up with them. We can see that in the spreads in the eurozone bond market where, as we said earlier, the yields on ten year Greek government bonds are more than twice those of Germany. That seal of international disapproval cannot be ignored for it makes refinancing of existing debt expensive and perhaps difficult and that is before taking into account the need to finance further deficits. Perhaps there is more tolerance of very large countries like the USA compared with smaller ones like Greece but the principles hold. The USA has a number of advantages over Greece including its ability to issue its own currency and the status of the US dollar as the world's largest reserve currency. The former means that a country can literally print its own money, although resorting to the printing process debases the currency, with perhaps the most glaring recent example being Zimbabwe although obviously in a completely different context. As the world's largest reserve currency and, therefore, widely held in other countries' foreign exchange reserves, there is a natural reluctance on behalf of the USA's creditors to cut off their nose to spite their face by aggressively selling the US dollar to the detriment of the remainder of their holding of US dollars. At the moment, the US dollar is benefiting from the woes of the eurozone but the US administration, building up an alarming amount of debt, has no room for complacency. We have been reminded that the bond investors do not have an unlimited appetite for debt, as the recent sharp and sudden upturn in US government bond yields show. It is a warning across the bows for the USA. So, whilst we can be slightly more relaxed about the vast build up of debt in the USA compared with what is occurring in smaller counties, it is only postponing severe debt problems if it continues to outspend its revenues so alarmingly. As in the eurozone, government bond yields look inadequate in view of the potential risks involved, particularly, in the case of the USA, with the continued prospect of a vast supply of Treasury bonds being offered for sale.

There is one further political issue for the USA, which could prove difficult if not handled properly, and that is relations with China, which holds the world's largest foreign exchange reserves. Latent protectionism in the USA and Europe are always of concern, particularly when economic conditions are difficult, such as now. Thus, in the USA, there are shrill calls for action against China because of its currency policy, which critics regard as protectionist. They want China to be accused of currency manipulation as a means of seeing tariffs imposed on Chinese imports. It is doubtful whether those putting forward such a proposition understand the consequences of what they are suggesting. Whilst it is attractive politically to protect home town interests, protectionism is a no win situation for almost everyone. As is well known, China does not take kindly to being told what to do, so pressure on China to allow the renminbi to rise is counterproductive. China may well have good reason to allow its currency to appreciate, the main one being to contain inflationary threats, but it is certainly not going to allow this to happen if other countries threaten it. If protectionist measures become prevalent, then depression is a prospect. A trade war will slow down or reduce the volume of world trade and will impoverish many consumers as they are forced to pay more for protectionist increased prices of goods and services thus reducing their spending power and having a negative multiplier effect on their particular economy. Those in the USA, in particular, but other protectionist minded countries as well, would do well to bear in mind that China could retaliate with devastating effectiveness, even though it would be hurt badly as well. By dumping US Treasury bonds and selling US dollars, Chinese retaliation could be lethal for the US economy. This is the "nuclear" option and, although one hopes that wiser heads will prevail, investors need to keep this possibility at the back of their mind. With midterm elections in the offing in the USA this November, protectionist fervour may raise its ugly head.



Although neither the USA nor China would officially admit it, the economic relationship between the two countries has benefited both. For China, an undervalued currency, whilst being a protectionist tool in effectively subsidising exports, has helped to maintain a fast rate of economic growth which, from a Chinese perspective is necessary to absorb those coming into urban areas from rural areas. China needs fast growth in order to maintain social stability. The accumulation of US dollars and other currencies arising from the large trade surplus is recycled, in the case of the USA, to purchase US dollar debt. So, whilst the USA might complain about the undervalued renminbi, the resulting Chinese surplus has been recycled making its trade deficit financeable. This is not a situation which can endure for ever but it requires cool heads and far sighted politicians, not grandstanding ones looking no further than the next election. One's best guess is that, if left alone, China would allow the renminbi to resume its appreciation against the US dollar as it attempts to restrain inflation following the enormous economic boost given to the Chinese economy in 2009 which it was able to undertake because of its relative economic strength. Rises in bank reserve requirements, together with administrative direction of bank lending, related measures taken to reduce the risk of inflation, would be consistent with allowing the renminbi to strengthen. For investors, therefore, one of the major influences on markets in the coming months could be the outcome of the US review of Chinese actions with regard to their currency. If accused of currency manipulation, the stakes will rise dramatically.

Not greatly mentioned in discussions on countries which are at high risk because of their level of budget deficits or overall level of public debt in relation to GDP, is Japan, which has one of the worst overall public debt to GDP ratios of all. Despite this, the financing of the deficit has never been a problem and foreign ownership of Japanese government debt is at very low levels. But personal savings rates with changing demographics are coming down rapidly thus reducing a source of demand for Japanese Government Bonds ("JGBs"). The big Japanese institutions remain buyers and the very low level of interest rates prevailing in Japan make the financing of such vast deficits possible. But, of course, this situation may not last forever. However, for the moment, and probably for some time, Japan remains off the radar of those probing for weakness in a particular country.

Not so the UK, which we continue to regard as a high risk economy and where it is difficult to overestimate the seriousness of the economic situation, in particular, the astonishing levels of what broadly may be called the budget deficit. One still has the feeling that most people do not appreciate the extent of the crisis in public finances or the adjustments which will have to be made, hopefully voluntarily. The UK may come under severe pressure from the markets or, ultimately, the IMF if the UK has problems refinancing its debt or borrowing in international markets. In recent reviews, we have dwelt on the weak financial position of the UK and we make no apologies for doing so because the accounting currency of most of our clients is sterling. Working out what investments to hold in these circumstances is of paramount importance for, in a sense, one is investing negatively, because one is seeking protection from the worst happening in the UK whilst hoping for the best, rather than positively, to benefit from the growth of the world economy. We liken the present position in the stock market to taking out an insurance policy against a serious problem occurring in the UK. Of course, we have always been very international in our investment outlook, with the UK being one of many countries in which we can invest, so the issue is not one of being over exposed to the UK economy but rather to a currency or funding crisis. So far, the insurance premiums represented by a substantial international equity position in relevant portfolios have justified themselves but we now need to look ahead.

Unfortunately, and probably damagingly for the UK, decisive action on the deficit has been postponed as a result of the forthcoming General Election. Because of the seriousness of the UK's financial position, this is probably an election where it is better for politicians to be completely up front with the electorate about what will have to be done to restore the UK's public finances even if it means losing the election. For public acceptance of measures, far more drastic than most people will have seen in their lifetime, will be less difficult to achieve (although it will still be very difficult) if voters have been prepared for them. One has the impression that, whilst most people



understand that public finances are bad, the full magnitude of the disaster which has befallen the UK's public finances is still not appreciated. For that, the politicians are to blame for, almost without exception, although to different degrees, the measures necessary to reduce the deficit have not been spelt out for fear of losing votes. The Irish measures to deal with the crisis in its public finances are indicative of what will have to happen in the UK, yet one feels that very few people are expecting anything like the cuts which have been announced in Ireland. Talk of efficiency savings and low priority spending are meaningless. The size of the state will have to be scaled back dramatically since tax rises, although some more seem inevitable over and above those which have already been announced, can only take a country so far and may already be counterproductive. There is likely to be serious industrial unrest after the election.

It is some progress that all three major political parties agree that there will have to be severe cuts in public spending but none have spelt out the full severity of what this will actually mean, no doubt for fear of frightening the electorate. But this rather leisurely progress to reality could come unstuck at any time. When a country has to borrow as much money as the UK does, it is vulnerable to a loss of confidence at any moment which could manifest itself in a fall in the currency's international value and a rise in government bond yields. Whatever the theoretical rights and wrongs of cutting earlier rather than later, which is dominating the political debate in the UK at present, the fact is that international holders of sterling and/or government bonds may not care for these niceties. They see a yawning deficit and want to see a credible plan for its reduction. Aspirations are not enough. With such weak fundamentals, a crisis could occur at any time in the UK. One has to say that the politicians, at least this side of the General Election, do not seem to have a credible plan. One has the feeling that politicians have not prepared the electorate for what is to come by way of the adjustment in the economy which is necessary to stabilise the financial position.

That being the case, we believe that the investment policy for sterling based investors must be based on the worst case scenario whilst hoping for the best. We have made this point in several of our recent reviews and it bears repeating. The possibility of a "hung" Parliament raises the stakes even higher. A decisive result for either of the main parties is the most desirable outcome because whatever the politicians say now they will have to address the deficit problems after the General Election. They are likely to make a serious attempt at a programme of deficit reduction if they have a majority in the House of Commons. A hung parliament is a real concern because, from what one can see at present, common agreement between the parties seems likely to be difficult to achieve. Maybe an adverse reaction in markets to such a result may bring about the desired result, but it could be a very painful time. In these circumstances, geographical diversification, which has always been an important aspect of our investment policy, should be of value. As the relative economic prospects of the UK have deteriorated over the past two years, the pound's overall value has fallen quite sharply, and this has been of great assistance in supporting the value of the assets of sterling based investors. Although we do not invest in overseas equities for currency reasons, it is quite possible that this aspect will provide an important insurance policy in the coming months. Although they have been rising, we see equities as the most relevant way to address this very difficult situation for sterling investors. Whether they be British companies with major overseas businesses, directly or through exports, or overseas companies, they reflect investments in real wealth, creating assets and companies which are used to dealing with the vagaries of different economies and fluctuating exchange rates. They will be exposed to economies which have superior growth prospects to the UK and some other sluggish economies, some of them situated within the eurozone. With still reasonable dividend yields available in most markets and modest price/earnings ratios based on some recovery in corporate earnings and dividends this year, some support can be given for what might be considered a rather unorthodox way to protect wealth in such a difficult economic environment. For bond investors almost everywhere, yields look unappealing in the face of the headwinds involved but, for sterling investors, UK government bond yields look completely inadequate to cope with the prospect of a continual huge supply of bonds with no guaranteed buyer now that quantitative easing has ended, at least for the time being, and uncertainty over the outcome of the forthcoming General Election and



whether the next government, whether it be one with an overall majority or a formal or informal coalition, will show the necessary resolve to make the cuts in public expenditure necessary to return the UK's public finances to some sort of sustainability. For foreign investors, the currency risk will be another factor. The best case scenario is that the necessary disciplines are imposed but, whatever the outcome, the outlook for the UK economy and other countries with a serious problem with public finances, is one of slow growth as the impact of public expenditure cuts and tax increases bears down on growth.

All of this may seem very depressing but it is important to be realistic. It does not mean that shares are bound to do badly - quite the opposite, in fact, if our view is correct, although no one must get carried away by the equity returns last year and so far this year. It bears repeating that the public finances of some countries, such as the UK, and some eurozone countries of which Greece is the most high profile country, are in as serious a position as they have been for a long time and that the adjustments which will have to be made will be on a scale that most people will never have experienced. These areas are where the most immediate problems are to be found but the USA and Japan cannot be complacent. They have major problems as well but may not feel the pressure of markets as immediately for reasons which we have given earlier.

The weakness of public finances in the West and Japan is increasing and will continue to increase the transfer of economic power to Asia, outside Japan, and to China, in particular, as well as parts of the Middle East and countries like Brazil and, perhaps, Russia. The relative economic decline in the West and Japan has been apparent for a long time but is visibly accelerating now because of the financial problems of these countries which we have been discussing above. Asian economies are large creditor countries and, as we discussed earlier when airing concerns about the dangers of American protectionism, the importance of China in helping to finance the USA's deficit is there for all to see. So this should put a constraint on some of the wilder demands of the protectionists in the USA.

The good news is that international investors can take advantage of these power shifts in the world economy by taking direct or indirect interests in these faster growing economies or, indirectly, through US, European or Japanese companies which have exposure to these areas and will benefit from such exposure. Although the West and Japan are in relative economic decline, it is fortunate that history has given them companies which have been very international in their outlook so that investors can still obtain the benefit of exposure to the faster growing areas of the world economy through their domestic markets as well as direct investments in them. When the UK had very serious economic problems in the 1970s and had to seek assistance from the IMF, UK investors were hamstrung in their ability to invest overseas because of exchange controls meaning that they had to buy currency at a premium and, at its worst, surrender a quarter of the proceeds at the official rate thus making switching extremely expensive. Although we would argue that the economic situation is, in a number of ways, worse now (the budget deficit is roughly double the level it was than at its worst) at least investors have more flexibility in their investment policy to recognise economic trends without having to pay expensively for it, although it would be fair to say that sterling's recent weakness has been a major expense for sterling based international investors.

So far, this review has concentrated on the dangers of the present international economic situation, particularly the debt issue surrounding the public finances of many countries, but international equity markets would not have advanced solely on the basis of cheap and, in some cases, newly created money, and relief that the international banking system was not going to collapse. Markets needed to scent better times compared with the grim days at the end of 2008 and beginning of 2009. Better times are coming because of the effect of the huge monetary and fiscal stimulus given to the world economy by governments and central banks. As companies scrambled to reduce working capital requirements, stocks were run down, in some cases to excessively low levels, so a rebuilding or stabilisation of stock levels is helpful to economic recovery. So, from the nadir of the first quarter of 2009, projections are for a modest recovery in 2010, continuing into 2011. The table below is an excerpt from the IMF's World Economic Outlook Update published in January 2010. The figures for 2009 were its estimate



then and, in the light of subsequent information, revisions will have occurred, but they importantly highlight the difference between the dire 2009 international economic experience in much of the world with the modest recovery from those depressed levels this year and, in present evidence, next year.

IMF Projections (world output year over year % change)			
	2009	2010 (projection)	2011 (projection)
World output	-0.8	3.9	4.3
Advanced economies	-3.2	2.1	2.4
USA	-2.5	2.7	2.4
Eurozone	-3.9	1.0	1.6
Germany	-4.8	1.5	1.9
France	-2.3	1.4	1.7
Italy	-4.8	1.0	1.3
Spain	-3.6	-0.6	0.9
Japan	-5.3	1.7	2.2
UK	-4.8	1.3	2.7
Canada	-2.6	2.6	3.6
Newly Industrialised Asian economies	-1.2	4.8	4.7
Russia	-9.0	3.6	3.4
China	8.7	10.0	9.7
India	5.6	7.7	7.8
Middle East	2.2	4.5	4.8
Brazil	-0.4	4.7	3.7

Source: IMF World Economic Outlook Update - January 2010 (excerpts)

The evidence from earnings' reports which we have seen so far suggests that companies were very quick to take action to protect themselves when the financial storm blew up and have been able to derive significant benefits from the slightly improved economic environment being experienced in most countries. Operational gearing benefits have often been significant, it seems, providing the prospect of the start of a recovery in earnings and dividends. As the forecasts show, it will be an uneven recovery. Debt laden western and Japanese economies' growth is likely to be sluggish but Asia, except Japan, is likely to improve strongly and there should be meaningful turnrounds in the Russian and Brazilian economies.

Over many years in these reviews, we used to detail some salient economic indicators from various countries and regions to indicate the way economies were moving. When the financial crisis struck in 2008, these indicators became almost meaningless, such was the gravity of the crisis, and we concentrated on the big picture and what it might mean for markets in what was an unprecedented situation. As we all know, and as we have discussed above, we are nowhere near being back to normal, but the world economy is slowly moving in that direction so we will end this review with some of the data which supports this view. At the height of the financial and economic storm, all of the data was negative, but now there are some positive indicators appearing, albeit that they are still outweighed by negative data.



In the USA, the US economy expanded at an annual rate of 5.6% in the final quarter of 2009. This was lower than the previous estimate of 5.9% growth but still reflected a sharp recovery. The ISM's index for the US manufacturing sector remained in positive territory for the seventh consecutive month in February at 56.5, albeit that it was down from January's figure of 58.4. The ISM's index for the US services sector rose to 53.0 in February, from 50.5 in January, this being the highest reading since January 2008. On the jobs front, fewer Americans lost their jobs in February than at any time during the previous two years. Non farm private payrolls fell by 20,000 during February, calculated on a seasonally adjusted basis. The unemployment rate held steady at 9.7% in February despite very bad weather which might have been expected to impact negatively on the figures. In the fourth quarter, US productivity rose at an annual rate of 6.9%, an improvement on the first estimate of 6.2%. Unit labour costs fell at a rate of 5.9%, a larger drop than the 4.4% initially estimated. This is relevant to our earlier comment on companies earnings often being better than expected. Retail sales rose by 0.3% during January and by 3.9% year on year. January's growth figure was revised down from 0.5% to 0.1%, but February's figures were achieved in the face of very bad weather. The Commerce Department reported that orders for durable goods in February rose by 0.5%. This was the third consecutive monthly increase.

In the eurozone, the Purchasing Managers Index gauge of activity rose to 54.2 in February from 52.4 in January, the fifth consecutive month that the index has been above 50. Industrial output in the eurozone rose by 1.7% in January and that followed an upward revision of December's figures to show a rise of 0.6% compared with a fall of 1.7% initially reported. Markit's purchasing managers Index for the services sector of the eurozone rose to 53.7 in March from 51.8 in February, this being the highest level since November 2007. That for manufacturing rose to 56.3 in March from 54.2 in February.

In China, official figures showed that retail sales in China rose at an annual rate of 17.9% in February, up from 17.5% in January. In Australia, a beneficiary of strong growth in China, official figures showed that Australian GDP rose by a seasonally adjusted 0.9% in the fourth quarter following a rise of 0.3% in the third quarter and an increase of 2.7% on the previous year. As well the Chinese demand for the country's mineral exports, a government stimulus package also helped to boost demand. In the UK, the CIPS/Markit manufacturing purchasing managers index stayed at 56.6, the same as in January. Nationwide's gauge of consumer confidence rose from 73 in January to 80 in February, nearly twice the level of a year ago. The Recruitment and Employment Confederation's jobs index rose from 60.5 in January to 63.2 in February. The CIPS/Markit purchasing managers index for the services sector rose to 58.4 in February from 54.5 in January and this was the highest level since January 2007. The Department for Communities and Local Government reported that house prices rose by 2.2% in January to give an annual gain of 6.2%. According to Hometrack, house prices in England and Wales rose by 0.3% during March, to give a rise of 1.3%, compared with a year earlier. The Council of Mortgage Lenders reported that about £9.2 billion was advanced to borrowers in February which was 6% higher than in January.

Taken as a group, these indicators may not strike one as being dramatic evidence of improvement in the world economy, but they do mark a shift in the balance from being totally unfavourable to a position moving more towards balance, although still on the side of negative data. Furthermore, as the effects of measures to reduce budget deficits and perhaps more normal monetary policy come into play, the pressure on employment will become much stronger in many countries. So what we can say is that they provide very modest room for optimism against a generally poor international economic background.

The international economic outlook, as we see it at present, leads us to the following investment conclusions. Where countries have large budget deficits and/or high levels of public debt in relation to GDP, the struggle to reduce these deficits is going to lead to some very hard decisions having to be made, such as has happened in Ireland. Where governments do not have the stomach to take the necessary measures, they risk a run on their currency, if not within the eurozone, and/or very much higher interest rates. The possibility of one or more sovereign debt



defaults arises. Whatever happens, the potential supply of sovereign debt is enormous and investors will want to be properly rewarded for the risks of buying it. In our view, apart from short dated issues, bond markets generally are overvalued and, in countries like the United Kingdom, very overvalued. As for equities, notwithstanding the recovery they have experienced since March 2009, they remain the most appealing asset class in our view. Partly, this is by default, since bonds remain unattractive, in our view, and the returns on cash are minuscule. Only if one was extremely negative about everything else would one consider the latter. Shares are obviously not as cheap as they were, although better than expected earnings from many leading companies validate current strength. Ratings, in terms of dividend yield and price/earnings ratios, are still reasonable. It is impossible to forecast short term price movements and there are bound to be setbacks from time to time, but exposure to real assets through good quality shares appears to us to be the most appropriate stance in these uncertain times. The major challenge for equities will occur when the extraordinary economic stimulus measures start to be reversed. It goes without saying, that the international economic outlook is very fluid and there are bound to be further surprises, but the above judgements reflect our stance against the economic and financial background as we currently see it.

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