meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

This has been a steady quarter for international investors with all those with euro-denominated portfolios showing a decline in value if their portfolios exactly matched the market. In local currency terms, nearly all markets showed a positive performance. Bond markets, as measured by the ten year government bond yields, were quiet. In currency markets, sterling's strength was only exceeded by that of the euro. In the commodity markets oil suffered a poor quarter.

The tables below detail relevant movements in markets:

International Equities 28.02.17 - 31.05.17

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.4	-5.4	-1.9	-7.3
Finland	+13.5	+15.7	+20.1	+13.5
France	+12.0	+14.2	+18.5	+12.0
Germany	+6.9	+9.0	+13.1	+6.9
Hong Kong, China	+9.5	+5.1	+9.0	+3.0
Italy	+12.3	+14.5	+18.8	+12.3
Japan	+2.9	+0.3	+4.1	-1.7
Netherlands	+9.0	+11.2	+15.4	+9.0
Spain	+15.0	+17.3	+21.7	+15.0
Switzerland	+9.3	+9.1	+13.1	+6.9
UK	+4.7	+4.7	+8.6	+2.7
USA	+2.6	-1.1	+2.6	-3.0
Europe ex UK	+9.4	+10.8	+15.0	+8.6
All World Asia Pacific ex Japan	+6.6	+2.9	+6.7	+0.8
All World Asia Pacific	+5.1	+1.8	+5.6	-0.2
All World Latin America	-1.0	-5.3	-1.8	-7.2
All World All Emerging Markets	+4.7	+1.8	+5.6	-0.2
All World	+4.1	+1.5	+5.2	-0.5

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.0%

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

Currency	28.02.17	31.05.17
Sterling	1.08	1.07
US Dollar	2.35	2.23
Yen	0.05	0.04
Germany (Euro)	0.21	0.29

Sterling's performance during the quarter ending 31.05.17 (%)

Currency	Quarter Ending 31.05.17
US Dollar	+3.8
Canadian Dollar	+5.7
Yen	+2.6
Euro	-2.0
Swiss Franc	+0.2
Australian Dollar	+7.2

Other currency movements during the quarter ending 31.05.17 (%)

Currency	Quarter Ending 31.05.17
US Dollar / Canadian Dollar	+1.8
US Dollar / Yen	-1.1
US Dollar / Euro	-5.6
Swiss Franc / Euro	-2.2
Euro / Yen	+4.7

Significant Commodities (US dollar terms) 28.02.17 - 31.05.17 (%)

Currency	Quarter Ending 31.05.17
Oil	-8.6
Gold	+0.8

MARKETS

Except for euro denominated portfolios, it has been a mildly positive quarter and, for international equities, this must be considered satisfactory in the light of a string of previously strong quarterly returns. In total return terms, the FTSE All World Index returned 4.1% in local currencies, 1.5% in sterling terms, 5.2% in US dollar terms and -0.5% in euro terms. Looking at local currency returns first, the stand out area was Europe ex UK with the FTSE Europe ex UK Index returning 9.4%. The only negative return was seen in the FTSE All World Latin American Index which returned -1.0%. In sterling terms, because of the weakness of the US currency, the FTSE USA Index returned -1.1% and the weakness of the Australian currency led to a return of -5.4% in the FTSE Australian Index. In sterling terms, the weakness of the FTSE All World Latin American Index was more pronounced with the index showing a return of -5.3%. The strength of the euro meant that the FTSE Europe ex UK Index returned 10.8%.

Bond market movements, as measured by the ten year government benchmark gross redemption yields, were relatively quiet by some recent standards. The yield on the UK government bond fell by 1 basis point to 1.07%, on the 10 year US Treasury bond by 2 basis points to 2.23%, on the Japanese government bond by 1 basis point to 0.04%, whilst on the German Bund the yield rose by 8 basis points to 0.29%.

In the foreign exchange market, the euro was the strongest currency. Against the euro, sterling fell by 2.0% but against the Australian dollar it rose by 7.2%, against the Canadian dollar by 5.7%, against the US dollar by 3.8%, against the yen by 2.6% and against the Swiss Franc by 0.2%.

In the commodity markets, oil, as measured by Brent crude fell by 8.6%. Gold was little changed, up 0.8%.

ECONOMICS

As regular readers of this memorandum will have noted, there are various consistent messages which underwrite our thoughts on investing. One is that acceptable risk-based returns are available for a long term investor in equities. This is borne out by analysis of the asset class which can now use statistically significant data which spans over 100 years. A second message which accompanies, and which for a variety of reasons precedes the first message, underlines the unvarying health warning that equity markets will always be subject to volatility and that the level of volatility at any time will be, well, volatile. For many, the peaks and troughs of equity investing create a level of discomfort which will mean that the journey is too uncomfortable a way of getting to the end goal. For those for whom there is no risk of becoming a forced seller, who can accept the long term nature of owning shares and for whom confidence in the likely outcome justifies the means, equities have their place.

As we approach the mid-point of 2017 we continue to remind those clients that there is a risk of negative quarters but, again, the regular reader will have noted that we have been warning clients of this for quite some time and yet markets have been showing remarkable levels of resilience. Looking back at the FTSE World index, total return in local currencies over the past five years (March 2012 to March 2017) - five years which have had their fair share of events that at the time seemed worrying and created uncertainty, have been above trend. The index has risen in 16 quarters and fallen in 4, leading to a total return of 74.4% or 11.8% annualised. The return in sterling terms is higher with the index rising in 17 quarters and falling in 3 and achieving a gain of 99.6% or 14.8% on an annualised basis. All of the outperformance of the sterling based index has been achieved in the past five quarters as a consequence of the recent reduction in the value of the pound. Equities continue to be well supported and volatility is low at present, though, again, it is necessary to caveat heavily that sentiment can change quickly and it is the unexpected, the unplanned or the unintentioned that has the capacity to be the most disruptive, especially in the short term.

The starting point to holding shares is the notion that the investor is buying a small part of a large business and with it has a claim over the future earnings of the business. Those future cash flows are discounted back to a present value on which the market takes an ever changing view – the share price. It is not possible to say at any time what the exact value of a company is, rather, the share price at any instant is a balanced consensus level where the number of buyers and sellers is equal. In strong bull markets, buyers' confidence grows and buyers outnumber sellers forcing share prices higher until more holders are inclined to sell bringing the balance back into equilibrium. Buyers' confidence is an ongoing assessment of a business's growth trajectory (or not) but as much as that it is macroeconomic factors that can move markets around. Both factors have coincided over the last six months in the United States with the election of the new President accompanying a strong reporting season.

Looking at the US equity market, the largest in the world and one to which most of our clients are exposed, it has finished reporting its results for the first quarter of 2017 and in doing so has provided investors the opportunity to re-consider the growth prospects of its constituent companies. It was seen as an important quarter as corporate earnings momentum has been weak in recent years and share price growth has been supported by a variety of other factors. Growth in earnings in the first quarter of the year was in double digits, year on year, and this was the first time this has happened since the fourth quarter of 2011. The ability to hold prices was also evident with quarterly revenues rising 7.8% year on year. Again this was the first quarter of such growth for over five years. Clearly this is exactly the sort of news which justifies share price rises without stretching valuation metrics such as price/earnings ratios. The S&P 500 index has now risen around 20% since its mid-2016 low and earnings growth has accounted for only a part of it. The so-called 'Trump trade' has carried valuations higher as confidence has grown that the new administration is undoubtedly pro-business with expansionary policies such as tax cuts and cuts to regulation. Share prices are always forward-looking and we are now in the phase of government where pre-election politicking, inauguration speech grandstanding and early term posturing must finally be converted into economy-expanding policy.

The earnings growth is welcomed and counter-intuitively coincides with U.S. economic growth being patchy compared with most of the past five years. Markets will increasingly want evidence that policy will be implemented that can provide the environment in which companies will continue to grow their bottom line. Capital investment will boost demand in the economy, boosting income and spending power in Main St. A purge of red tape will reduce operational inefficiency. Tax breaks for companies should encourage them to repatriate money and to invest in their businesses. Confidence breeds confidence and, then, growth will grow. It would be easy to think that Donald Trump tackles his new role along the lines of being a chief executive, especially as he has a majority in both houses of Congress. Everything would appear to be lined up behind him. He would be forgiven for thinking that, still, what he says, goes. The reality is showing us, and him, something different and it would appear increasingly that the holder of the highest office needs to have such skills as building consensus, being a diplomat and showing discretion. The risk to his growth plans is that the more autocratic his style the harder it will be to push through contentious legislation on spending and tax. All political parties are coalitions and, insofar as this is true, the Republican Party has its own ecosystem of views. There may be a changing view on whether Donald Trump's presidency can continue to be a tailwind for the country.

There are various reasons for this. Trump ignited optimism in his homeland during his electoral campaign with his easy-to-digest messages and his talk of 5% GDP growth. Investors adopted the direction of travel and found it easy to discount his more erratic posturing. Now, at the beginning of June, scepticism grows around his capacity to drive through those pledges. Congress's support for Trump on key areas, such as tax reform and infrastructure spend, is waning and without that support change in these areas is impossible to achieve. There would be very few in the country who would argue against deregulation - a common sense supply-side reform that could grease the cogs of commerce. The reality is that such a task is time-consuming and fraught with risks of unwanted consequences. Whilst Congress is moving forward on unwinding the so-called Obamacare health initiative, progress on the "big number" Trump promised on dismantling Dodd-Frank and other financial services legislation is slowing greatly. The premise for such Obama-era legislation was both strong and reactionary and most believe that reform of such post-crisis measures is necessary to remove a constraint on the economy; it now looks like the framework of rules will remain in place but the burden on banks will be reduced within the existing framework. US bank stocks rose 20% in the last two months of 2016 but have levelled off more recently. Whilst its shortcomings are many, it is difficult to strike through legislation that sets out to improve transparency in the financial system, to end "too big to fail", and to protect consumers from abusive financial services practices. Progress on deregulation will be measured over years and will contribute to improved productivity but will not generate the productivity gains necessary to increase GDP growth by the magnitude hoped for by the new President.

The thread that now appears to be running through all of these political projects is that President Trump is a man whose behaviour goes beyond the established norms of presidential conduct. He seems decisive and yet changes his view, he appears confident and yet is distrustful and he speaks for a nation but his word is increasingly doubted. His camp appears to be divided into the protectionists and the globalists and he has already sacked three key aides in his first four months, normally a quota fitting of a whole term. If President Trump does not succeed in becoming more effective, the prospect of his flagship manifesto pledges becoming policy looks increasingly remote. Implicit in his mandate was the understanding that he was a doer and his term is likely to be viewed very critically very quickly unless progress is made. As it stands markets are giving him the benefit of the doubt.

It is not coincidental that markets rise when politicians talk of free market, non-interventionist politics and it is our view that healthy, competitive and open markets where companies can both thrive and fail are an economic good. Free markets and, particularly, their constituent companies are capable creators of wealth, employment and innovation but, given that they can sometimes illustrate some of the worst traits of human behaviour as well as the best, do not always enjoy the support of the press and particularly at the time of elections, most colours of the spectrum of politics. Which brings us on to the U.K.

At the time of writing the General Election is upon us and at the time of reading the result is probably known. The purpose of this memorandum is to comment on factors that are in play that relate to the investment world and first amongst those factors would be macroeconomics. It is not possible to divorce politics from macroeconomics and, of course, the moving political landscape has profound and often immediate effects on foreign exchange levels, interest rate markets, and appetite for bonds and equities. In the context of the 8th June U.K. General Election, and without the intention of this becoming a political piece, it is worth considering what the chief executive officers of the FTSE 100 companies may see in manifestos and what the consequence would be of those pre-election pledges becoming policy.

An obvious starting place is corporation tax. Labour's manifesto included a pledge to raise corporation tax for the largest companies to 26% from 19%, something that could raise as much as £19.4bn. per year. This would break with 44 years of government policy where the tax as it is currently known was introduced in 1973 at a rate of 52% and has only been cut since. In political terms the move has some appeal especially when looked at for its primary effect. For a country where government debt approaches 90% of GDP - an historically high level, the ability to direct almost £20bn. of new taxes into worthy causes is very valuable, in various ways. The question is what are the secondary and longer term effects on the country of raising the corporation tax rate? Will chief financial officers simply report a lower post-tax profit figure and reduce dividends accordingly? The Institute of Fiscal Studies, citing evidence from the OECD, reacted to this announcement by opining that the rise would be "pretty bad for investment, jobs and wages". The pressure on free cash flow in businesses is strong and tough choices around investment and spending will become even tougher. The competing forces on the scarce resource of working capital would get much stronger. Companies consider many factors when considering where they are domiciled but a significant rise in tax would necessarily be for discussion in boardroom meetings. Companies are more mobile than ever and there is the small consideration of Brexit which entertains similar themes. Companies' ability to use effectively tax planning methods is a reality and governments need to accept that there is a chance that the headline year one gain may diminish in subsequent years. The United Kingdom, more than ever, needs to ensure it is attractive to companies and those businesses have recently had to adapt to higher business rates, a raised minimum wage as well as ever increasing compliance costs. Swimming against the international tide and raising corporation tax would be a risky strategy albeit one that would provide funds for over-stretched services up and down the country. There are always uncomfortable headlines generated by companies that are highly effective at structuring their tax affairs in a way that their effective rate of corporation tax is unusually low. The realpolitik is that more of this will go on if taxation rises and policy needs to consider that fact, even if it is considered unpalatable.

Mrs May has her own ideas which could have their effect on business decisions. One idea is to reduce immigration to the "tens of thousands". Whilst this may be for voter appeal, if carried through could be harmful for the economy. It may also prove to be an intention that gets subsumed in the Brexit negotiations as previous Cameron-era pledges were not followed with reduced immigration to such low levels. She has also talked of employees being put on boards and protectionist rules around takeovers of British companies. These all have their superficial merits but there is always the risk that companies may increasingly find arguments to do business elsewhere instead of in the U.K. The economic standing of the British economy has been built on the strong rule of law, openness and low bureaucracy. This is relative, of course, and in the World Bank's most recent Ease of Doing Business index, the United Kingdom ranked 7th in the world with only two European countries ranked higher, being Denmark (3rd) and Norway (6th). New Zealand was 1st and Somalia was 190th. Again, the country faces a heightened level of sensitivity on these matters in a post-Article 50 world. Companies are, depending whom you ask, cash cows, social pariahs, wealth and growth creators and employers.

In investment terms, our view has always been that the United Kingdom represents a small part of the geography of the investment world and, so, it would take an unlikely vote of confidence in the British economy to weight it much higher than it represents. In terms of the market capitalisation of the world's companies the UK is around 6.2% of the FTSE All-World Index at the end of May and it has always been Meridian policy, where there are no constraints, to invest internationally. The logic here is that world growth is fairly certain but where it will occur and at what rate at any time is less easy to predict. By investing internationally there should be a smoothing effect as companies around the world enjoy growth in their markets. This effect is doubled by investing in companies which, themselves, are international in their outlook and so each can change its strategy and investment to meet opportunity as it arises.

Moving into mainland Europe we find an improving picture. The recovery continues and inflows into European equities have been strong so far this year and equity markets have responded positively, growing faster than US markets (for the first time since the financial crisis) and the UK. An issue with this economic growth remains that it is not felt evenly across the euro area and, unfortunately, there is not any strong reason why it should. Looking at the first quarter GDP data, Latvia enjoyed the highest level of growth at +1.6% with Slovenia (+1.5%), Czech Republic (+1.3%) and Finland (+1.2%) not far behind. Halfway down the chart Germany matched the euro area average of +0.6% with France, Italy the Netherlands and Greece registering +0.4%.

It could be argued that exactly the same happens within, say, the United Kingdom and growth in Cornwall may not match that of Northern Ireland or Glasgow. The two principal differences would be that within the UK there is a sense of common national identity with one government and most taxes collected, centralised and re-distributed on a national basis. This, of course, is being tested by the Scottish National Party and other regional interest groups but the model is long-standing and, for many reasons, history and identity being two, there is finite resistance to the status quo. Europe, and in particular the countries which use the euro, have reached an important stage. The model has been severely tested by the financial crisis and the relative strengths of member countries has been shown to be as wide as ever. If EU members wish to continue on the path of ever greater integration, then the next logical step for those countries which share a currency would be to have a common treasury which distributes centrally paid taxes. Tax receipts would then be re-distributed on a needs basis and, under the Law of Comparative Advantage, improved trade between countries would be to the benefit of all. The sticking point here is that national borders still exist and the sense of nationality continues to flourish. The prevailing movement of re-distributed taxes would most likely be from north to south and politicians on the national stage in certain paying countries seem reluctant to sell this to their voters. As well as the flaw in the economic model there is a flaw in the social model where if those voters see their national identity as more important than their European identity then it is likely they will resist this most important step.

Convergence within the European Union has been seen amongst the countries of central and eastern Europe as the direct foreign investment, open borders and their low starting base has been the foundation for great economic progress. It has been relatively easy for those countries to achieve a growth in GDP level which is consistently higher than their neighbours in north and north west Europe. The lack of convergence among the 12 countries that adopted the euro around the start of the millennium is far more striking. Convergence supports the smooth functioning of monetary union but, we are learning, monetary union does not necessarily support convergence. According to a 2015 report by the European Central Bank, convergence failed to occur in the eurozone in the period 2000 to 2007 for three main reasons. Firstly, institutional conditions varied from one country to another meaning that business innovation and productivity growth were not uniform. Secondly, national rules which create structural rigidities have reduced cross-border competition and, thirdly, the sharp drop in interest rates created excessive cheap lending which pushed up demand, distorting expectations about future growth especially in less wealthy countries. A good example of this was the property bubble in Spain.

Since the financial crisis an important pre-condition for convergence has been lacking - economic stability. Again, using the most obvious example, Greece is now further from convergence with the other most obvious example, Germany, than it has been for many years. It is not possible for economic demand to grow at a catch-up rate as it did in Romania, Bulgaria and others mentioned in the previous paragraph. A second pre-condition for convergence is the need for productivity growth to be strong in those weaker countries as capital is attracted to a lower cost base seeking comparative advantage. This has not been as successful as hoped as rigidities in product and labour markets in countries which would have benefitted from a more flexible economy have not been able to adopt such change. In straitened times stripping away employee entitlements is very difficult.

Each quarter the exact order of growth amongst the eurozone countries changes but there are certainly recurring patterns that form a trend in the longer term. Looking at the per capita real GDP of each country since 2008, Germany's economy is now almost 6% larger than nine years ago, the Dutch economy is 4% larger whilst the Italian economy is smaller. In May, the Governor of the Bank of Italy forecast that GDP would return to its 2007 level in the first half of the 2020s, commenting "Apart from the cyclical factors, Italy's economic development is hampered by rigidities in the business environment, the slow growth of productivity and an insufficient employment rate"

As mentioned at the beginning of this piece is the current conundrum of volatility, or the absence thereof. It would follow that, in settled times, with little political or economic news and with companies quietly growing their income in line with expectations, more gradual re-valuations of those companies would follow. It also follows that it is surprises, of any form, which disrupt the mechanics of price discovery and create volatility. Given that this is true, it must either be that current capacity for high level political upsets is not acknowledged by market participants or those buyers and sellers acknowledge these upsets but do not believe them to be as troubling as the headlines suggest. Examples of these would be the ability of President Trump to deliver on his pledges, the threat of economic nationalism typified by tariffs, quotas and other trade barriers, the record level of indebtedness, generally and in specific countries such as China, and the reversal of quantitative easing. To these can be added Brexit and the UK General Election, cohesion in Europe, volatile commodity prices inter alia.

The market for shares also finds new influences on it. The US market alone has seen $5 trillion of share buy backs over the past five years, quantitative easing on such a scale that it must be considered an experiment has inflated almost all asset prices, passive investments such as exchange traded funds are now bought and traded extensively with such funds now owning nearly 20% of every major American company, and then the paucity of alternatives is cited given such low interest rates and expensive bonds. These phenomena, to the extent that they have happened, are new and so we do not find any historic reference points so that they perhaps contribute to the sense of a reluctant bull market with even the low volatility being construed as a negative.

Beyond the geopolitics, the macroeconomics and also market factors such as those mentioned in the previous paragraph, the shareholder must, most importantly, look to the earnings per share of the companies he or she holds and how this metric may improve over the coming years. These companies will be used to navigating the cluttered political landscape and are in an endless cycle of change and re-invention. We remain confident that there continues to be good value in investing in shares and that the most successful companies are those that place a high value on the interests of their shareholders.

May 2017

ADDENDUM FOLLOWING 8TH JUNE U.K. GENERAL ELECTION

In the highly tactical world of modern politics it is important to know the answer before you ask the question. On 8th May 2017, the Conservatives, outside of the current Fixed Parliament Act, consciously chose to ask the country to pick its parliamentary make up and to , presumably, strengthen their mandate as the negotiations with the European Union approach. As we write, just twelve hours after the closing of the polling booths, the biggest political question has been answered, for now, and not in the way the Conservatives had hoped. The immediate reaction has been a noticeable but not alarming fall in sterling's value and a modest rise in the FTSE 100. This rise can be explained, to a large degree, by the fall in sterling with constituent companies that earn much of their income in foreign currencies, such as Rolls Royce, Diageo and Unilever, seeing their sterling value rising. Looking to the more UK-focused FTSE 250 of mid-cap companies the index is down around 1%, which could be said to imply some uncertainty, but does not point to any sense of panic. In bond markets the benchmark 10 year Gilt is more or less unchanged, with a gross redemption yield of 1.01%.

There is a need to comment on this significant piece of news but it is important to remind ourselves how close to the event we stand and that, certainly in the realm of politics, the coming months will be difficult to predict. We did not make any strategic changes to the asset allocation of our client portfolios in front of this election as the house style of investing is to invest in internationally focused companies, internationally. As outlined in the body of this month's memorandum, these companies have global reach, diverse income lines and are fluid in their constitution, all working to evolve to suit the political and economic weather. This provides a certain amount of insurance in circumstances such as the ones in which we find ourselves today; this is to say that a large political event has happened in a market that represents less than 7% of the market capitalisation of the world's stock markets, albeit the market to which we are most attuned. Uncertainty is unwelcome but is inevitable and it is impossible to invest in a vacuum. We shall continue to monitor the situation closely and are always available to clients to discuss such matters.

June 2017