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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

The tables below show a truly dreadful performance from international stock markets as the fallout from the financial crisis continues. Almost no asset market, apart from high quality government bonds, has been immune and this area, too, looks highly exposed. Whilst very little is going right at the moment, recovery will occur and we discuss later what the signs of this might be.

The tables below detail relevant movements in markets :

International Equities 29.08.08 – 28.11.08

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-25.7	-32.2	-43.8	-34.8
Finland	-34.4	-32.8	-43.5	-34.4
France	-27.7	-25.9	-37.7	-27.7
Germany	-29.9	-28.2	-39.6	-29.9
Hong Kong, China	-35.4	-22.7	-34.9	-24.5
Italy	-27.2	-25.4	-37.7	-27.2
Japan	-34.1	-10.8	-24.9	-12.9
Netherlands	-37.3	-35.8	-46.0	-37.3
Spain	-22.7	-20.8	-33.4	-22.7
Switzerland	-20.4	-14.5	-28.1	-16.5
UK	-23.2	-23.2	-35.4	-25.0
USA	-29.9	-16.6	-29.9	-18.6
Europe ex UK	-29.1	-27.2	-38.8	-29.0
Asia Pacific ex Japan	-30.4	-30.3	-41.3	-31.9
Asia Pacific	-32.5	-20.2	-39.9	-22.1
Latin America	-30.2	-38.7	-48.4	-40.1
All World All Emerging	-34.0	-34.4	-44.8	-35.9
The World	-29.6	-21.3	-33.8	-23.2

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +4.9%

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

Currency	29.08.08	28.11.08
Sterling	4.48	3.78
US Dollar	3.83	2.93
Yen	1.42	1.40
Germany (Euro)	4.17	3.26

Sterling's performance during the quarter ending 28.11.08 (%)

Currency	Quarter Ending 28.11.08
US Dollar	-15.9
Canadian Dollar	-1.5
Yen	-26.2
Euro	-2.4
Swiss Franc	-7.0

Other currency movements during the quarter ending 28.11.08 (%)

Other Currency	Quarter Ending 28.11.08
US Dollar/Canadian Dollar	+17.1
US Dollar/Yen	-12.2
US Dollar/Euro	+16.0
Swiss Franc/Euro	+4.9
Euro/Yen	-24.4

Significant Commodities (US dollar terms) 29.08.08 - 28.11.08 (%)

Significant Commodities	29.08.08 - 28.11.08
Oil	-53.1
Gold	-2.6

Markets

In a shocking quarter for world international equity markets, the FTSE World Index total return in local currency terms was -29.6%, -21.3% in sterling terms, 33.8% in US dollar terms and -23.2% in euro terms. The declines were widespread but sterling investors were able to show slightly less bad returns if they were invested internationally, given the weakness of the currency. That is shown in the relative returns of the FTSE World Index shown above in local currency and sterling terms. The two biggest gainers against sterling were the yen and the US dollar and that is reflected in a sterling return on the FTSE Japanese index of -10.8% and on the FTSE USA index of 16.6%, both significantly less bad than the average. Switzerland is also worth a note as the strength of the Swiss franc against sterling, plus a better than average performance from that market, left sterling investors showing a total return of -14.5%.

The beneficiary of the financial turmoil was the high quality government bond market and, taking ten year government bond yields as a benchmark, we note that the gross redemption yields on sterling bonds fell by 70 basis points to 3.78%, on US dollar bonds by 90 basis points to 2.93%, on yen bonds by 2 basis points to 1.40% and on German government euro denominated bonds by 91 basis points to 3.26%.

As touched upon in the first paragraph, there were some astonishing movements in the currency markets with sterling experiencing a dreadful quarter, falling by 26.2% against the yen and by 15.9% against the dollar, as well as by 7% against the Swiss franc, 2.4% against the euro and 1.5% against the Canadian dollar which was itself weak against the US dollar.

In the commodity markets, there was a dramatic decline in oil of 53.1% in US dollar terms whilst gold was only little changed, down 2.6%.

Economics

Because of the financial and economic background, we will, in this review, concentrate, as we have for the last two monthly reviews, on the bigger picture rather than include a review of individual economic pointers from countries and regions with the exception of the U.K. The news changes so quickly that there is very limited value in reviewing these. Rather, we will try to draw some conclusions from what is going on although, inevitably, these will be tentative and some will be wrong, so quickly are events moving.

Some progress has been made in the banking system. In October, serious concerns were expressed about the safety of bank deposits, not just with relatively minor banks, but with well known names. That is about as serious as it gets. People expect their investments to move up and down but they do not expect to have to worry about the security of their bank deposits. But this was a real worry back in October. Apart from, for example, the Icelandic banks' problems, governments' and central banks' actions in various forms have restored confidence in the major banks throughout the world. This has come at huge cost but confidence in the security of bank deposits is absolutely fundamental to the economic system. So, this, at least, can be regarded as progress. Progress has also been achieved in unfreezing the interbank markets although they are not yet back to normal. Because banks were hoarding cash and showing a reluctance to lend to other banks, interbank rates rose to exceptionally high levels relative to official interest rates. This made the effect of lower official interest rates much weaker because these interest rate reductions were not being passed on. In these circumstances, monetary policy could not be effective. By various methods such as government guarantees and central banks' acceptance of a wider range of collateral from banks in exchange for funds, the transmission effect of lower interest rates is becoming much more effective although, as yet, not fully so. Now, some governments, notably the UK one, are pushing banks to lend at reasonable interest rates to businesses, especially small ones, to help to get their economies moving and ensuring that businesses and individuals do not fail for want of finance. So desperate is the UK government for banks to lend that there is talk of the banks being forced to lend or, in extremis, nationalised. Given the assistance from the taxpayer, the government has a stronger hand but forcing banks to lend against their better judgement or to lend at margins which are not commercial because they do not price in the risk is fraught with danger. It could give the banks more bad debts and risk restarting the bad debts spiral. But banks are easy targets at present and, with public hostility towards financial institutions very high, governments may feel they have the whip hand. Nevertheless, notwithstanding the mistakes made by banks and the financial companies, it is highly undesirable for governments to start interfering in commercial decisions.

The best way to move forward on bank lending would be for confidence to grow in the world economy. Needless to say at the moment, this is almost non-existent. This can be seen in the stock markets, property markets, commodity prices, corporate bond markets and in the economic numbers indicating recession in many countries.

Firstly, let us discuss what is happening in stock markets. Equities are depressed and very volatile. Although the economic background is poor and the outlook for corporate earnings very uncertain with some dividends being cut whilst others are omitted, many stocks appear to offer good value. Especially now that interest rates are so low, the yields on many shares, where the dividend appears to be safe, look appealing. However, at present, we believe that stock markets are being heavily influenced by deleveraging, which is occurring in hedge funds, and sales of good quality securities are the main way to achieve cash. Together with deleveraging, hedge funds and open ended funds are facing heavy redemptions which have to be met through sales of securities if liquidity is not adequate. Forced sellers appear to be a major influence on markets, contributing to the current extreme levels of volatility. One of the causes of the financial crisis was excessive leverage. This is having to be unwound and banks will not be extending the same level of credit as before. Eventually, this forced selling will die down and more normal conditions will return but, by all accounts, hedge funds continue to face large redemptions as do open ended funds so the process will certainly continue for a while. One of the casualties of the financial crisis will be the hedge fund industry. Whilst it will obviously continue, it will be much reduced in size and the days of 2% annual charges and 20% performance fees are surely numbered for much of the industry. Apart from the failed strategies, in some cases, the problem is one of expectations. Many have not lived up to their billing of uncorrelated returns or even absolute returns in these markets. Prime brokerage activities will be scaled back and the level of leverage will no longer be available for many funds.

Another casualty has been corporate bonds. A loss of confidence in even good credits has led to very poor performance. Investors became so risk averse that they have driven down highly rated government bonds' yields to absurd levels. Some real anomalies have appeared in the market yet it will require a return of some economic confidence for more normal levels of yield to return. Meanwhile, for companies a source of finance has dried up or, if it is available, has become more expensive.

Another symptom of the financial crisis has been some major swings in the currency markets with, so far this year, an incredibly strong performance from the yen and a very strong recovery in the US dollar. In previous times, we have talked about the dangers of the "carry trade" activity which was in full swing as investors borrowed low yielding currencies such as the yen but also the Swiss Franc to invest in high yielding currencies like the Australian and New Zealand currencies. To us, it seemed a very high risk strategy particularly with the yen, in our view, being an undervalued currency. A vicious unwinding has taken place as investors reduce risk, no doubt resulting in some severe losses. Against the Australian and New Zealand dollars, the yen has risen by over 50% this year.

Of the major currencies, sterling has taken a major battering as confidence in the UK declines. The contribution of large internal and external deficits, together with an important financial sector which means the UK will be disproportionately hit by the financial crisis, has had foreign investors fleeing the currency. Although the UK government bond market has been strong as a flight to perceived low risk assets benefits it, the UK, taking ten year government bonds as an example, has to pay 50 basis points more than the German government for its funds and 80 basis points more than the US government. Should sterling resume its decline, we can expect a wider spread.

In other markets, residential and commercial property markets have weakened considerably. The US housing market was the home of the present financial problems. House prices in other countries, notably the UK, are now falling fast as the residential property bubble bursts. The prospect of negative equity or even just falling house prices acts as a significant brake on consumer confidence. Commercial property has also been notably weak. For cities like London and New York with major financial centres, the effect has been dramatic but the trend is worldwide. Developments will be held back even if the finance was available. The crossover of yields where the cost of money exceeded rental yields marked the speculative excesses in this market. Now the situation has been reversed but lack of demand is unlikely to tempt investors back into the market yet. Back to the residential markets, and we note the much hyped "buy to let" market has also suffered a severe reverse.

Commodity markets have also weakened with oil, for example, not much more than a third of its recent peak. Commodity markets attracted speculators and they, too, have retreated. This trend will help the disinflationary process and, for some counties, could lead to deflation, an issue we will discuss later.

One area which has benefited is the high quality government bond market on widespread loss of confidence in most asset types. Yields have been pushed down to extraordinarily low levels as, at the height of the banking crisis, many investors lost confidence in bank deposits. Should the world economy or individual countries move into a deflationary environment then current negative real yields or small positive ones could be more appealing. But it is difficult to believe that there is any kind of medium or long term value in most government bond markets. Inflation is likely to return as an issue at some stage, notwithstanding the disinflationary effects of what is happening at present, and the sheer volume of issuance in countries running large budget deficits can be expected to push up yields once investors become less risk averse.

So, how does the future look? Forecasts made and expectations held only very recently are now generally worthless, so quickly have events moved to invalidate them. One only, for example, has to look at the economic forecasts in last Spring's UK Budget and the latest one in the Pre Budget Report to see the change in the scale. On both occasions, the forecast looked optimistic and we will return to the particular position of the UK shortly. On some issues, we can be almost certain about what is going to happen. Regulation for banks and hedge funds is going to increase. Banks will become more like banks used to be, holding more conventional assets on their balance sheets. Hedge funds will become much more closely controlled, leverage will reduce, the range of opportunities will decline and the industry will shrink. One of the causes of the present problems is too much leverage which has raised risks and one example of where it has taken place is in the hedge fund industry. We can also be certain that taxpayer assistance in different forms to banks will be used by governments as a lever on the banks to do their bidding. This can be seen in the UK where intense pressure is being placed on the banks to provide a flow of credit at a reasonable price to businesses and individuals to keep the housing market and businesses alive. Such pressure is highly dangerous for it risks making the banks' capital positions worse if they suffer further bad debts. One can see why some banks were keen not to have the government as a shareholder. But politicians want to be seen to be doing something and banks are seen as an easy target in the current circumstances. So, one way and another, we can see governments, central banks and regulators taking a much more "hands on" approach to the financial sector. There is also bound to be a large element of self regulation by the banks and financial institutions. Directors and shareholders have experienced a severe shock and, on the rebound from this situation, are likely to become very conservative in their activities with the emphasis on minimising risk, rebuilding balance sheet strength and trying to take out government shareholdings where they exist. There should be an upside from this, which we can now see with the benefit of hindsight, which is that, when economic growth resumes, it will be at a slower rate than in recent years but be better quality and more sustainable.

In macroeconomic terms, we have to wait to see what is the effect of governments and central banks throwing money at the problem. By throwing money at the problem, we mean reflationary fiscal measures and lowering interest rates dramatically. In the short term, the world economic downturn will get worse. The collapse in business and consumer confidence means that weak demand will be a feature for the foreseeable future. Company collapses will remain a prominent feature of the financial landscape and rising unemployment will be a universal feature. At times like these, when the news seems universally gloomy, it is easy to believe that recovery in stock markets or the economy is never likely to happen. But, of course, it will, although turning points in markets are sometimes difficult to spot until after the event. An example of a turning point which was not immediately obvious at the time but which was the precursor of a substantial stock market recovery was 1974. Conditions seemed desperate. The leap in the price of oil led to very high inflation levels, quite a different situation to the present. In the UK, there were price, incomes, dividend and rent controls as the government tried to bear down on inflation. The secondary banking crisis was in full flow and there were worries about the health of one of the main UK clearing banks which was forced to issue a weekend announcement that it was not in trouble. The collapse of the property market was largely the undoing of the secondary banks and, because it was so important to the financial system, the government performed a U-turn and lifted the controls on rents. Because rent controls depress property values, this event paved the way for a stock market recovery predicated, amongst other things, on the view that the banking system, which had been a big lender to the property sector, was that much safer as a result of this action. Following on from that, as companies sought to rebuild their ravaged balance sheets, the Treasury effectively reversed part of the damage dividend controls cause by allowing exceptional increases for capital raising exercises of which there were many.

Although the parallels are different this time, there will be turning points. What might these be? As we have said, many shares look cheap. Dividend yields for many companies, where one would expect the dividend to be maintained, look attractive compared with bond yields or interest rates on deposit. Many of these shares may have been the victim of forced sales by funds having to raise cash. In due course, this phenomenon will run its course enabling the value in these shares to be recognised in a more predictable way in the market. Secondly, although attention in the corporate sector is focused on those companies with weak financial positions, there are many companies which have strong financial positions and are able to make opportunistic purchases. So, although merger and acquisition activity is moribund at present, we may expect to see flickers of activity which will then gather strength. A third factor is that the disinflationary factors in play at the moment will reduce cost pressures on companies and individuals and leave them with increased spending power which, if they choose to spend it rather than save it, may help to stimulate economic activity. This will have the same effect as interest rate cuts for individuals or businesses. However, we should also remember that there are more savers than borrowers and, for individuals who rely on interest income, the very low interest rates currently available reduce their spending power.

We should also look at further potential dangers for the world economy. It is possible that the recession will last longer than expected and develop into a depression. For most countries, given the size of the efforts to stimulate economies, this is unlikely. Lessons have been learnt from the Great Depression nearly 80 years ago. In a worst case scenario, we could go into a general period of deflation internationally rather than this being a phenomenon confined to a small number of countries. Deflation relates to the price level actually falling as opposed to disinflation where the rate of price increases falls. Only Japan, in recent years, has experienced deflation and, given that interest rates cannot fall below zero, monetary policy becomes ineffective in these circumstances. At present, Japan, the USA and Switzerland have minimal levels of official interest rates so there is very little scope for further interest rate reductions. The UK and eurozone have more scope although the fragility of sterling may be an issue for the Bank of England. However, in a deflationary environment a nil interest rate implies a real rate of interest. We all know how dangerous inflation can be. Apart from anything else, it eats into the real value of savings. But deflation can have very malign effects. If it is expected that the price level will fall in the foreseeable future, rational individuals and businesses will hold off purchases which are not strictly necessary. That can cause a collapse in demand exacerbating recessionary influences. Whilst inflation eats away at the real value of borrowings and puts the borrower in a more favourable position, assuming a rise in asset values against which the borrowings are made, deflation increases the real value of liabilities in capital terms and, depending upon what happens to normal rates, the real cost of servicing those liabilities as well. Such a situation could herald a depression. A further significant contraction in economic activity could put further pressure on banks' capital ratios, requiring a further infusion of new equity. If deflation does occur, and we think it unlikely for most countries, other than perhaps for the odd quarter, then governments and central banks will have to think of unorthodox measures to try to offset its negative effects.

We have a particular concern about the UK economy. Well before the implosion in the financial markets, we had expressed concern about the size of government borrowing and were not expecting a happy outcome. We also expressed the view that sterling was vulnerable even though it was riding high at the time. Obviously we had not factored in the financial crisis which subsequently occurred. The end result of this is that the UK is exceptionally badly placed to face the current problems in the world economy. The problem then was that the UK government was increasing public expenditure at a rate far in excess of the potential growth rate of the UK economy and the Treasury was consistently underestimating the level of public borrowing. Outside observers consider that the UK economy is badly placed to face adverse economic conditions. Some reasons are obvious besides the already unfavourable state of public finances. The UK has a large financial sector and a previously buoyant housing market. Revenues from corporate tax and stamp duty will be decimated not to mention income tax payments from those working in the affected areas. The level of household debt and the ramifications of the economic downturn will exacerbate economic weakness. Although, as mentioned at the beginning of this review, we are not going to detail economic data and projections because things are moving so quickly to make them out of date, we will make an exception for the UK to show the magnitude of the problem as presented in the pre Budget Report towards the end of November. Most commentators are highly sceptical of the forecasts which accompanied the PBR. The Treasury is forecasting growth of 0.75% this year, a contraction of 0.75% - 1.25% next year and growth of 1.5% - 2.0% in 2010, a forecast which has been greeted with much scepticism. The borrowing forecasts are eye watering.

For 2008/9 government borrowing is forecast to be £78 billion rising to £118 billion in 2009/10, after which it is forecast to fall. There are so many imponderables that it is difficult to know how accurate these forecasts will be. But, even if the forecasts are correct, £118 billion represents 8% of GDP, a shocking level of borrowing. Had a more prudent policy towards public finances been followed as in Germany, for example, the starting point for government pump priming would have been much better. Why do these horrendous borrowing figures matter? Internally, it has to be financed and this increases the tax burden for present and future generations and will be a drag on economic growth and, therefore, prosperity. But the more immediate threat is an external one. We have noted how much sterling has fallen, reflecting reduced foreign confidence in the UK economy. Government borrowing has to be financed and, with a poor internal and external financial position, foreign investors, an important source of finance, could well take flight. At the very least, they might demand higher interest rates than the paltry ones on offer at present and the possibility of a foreign exchange loss might make them even more cautious. The dire state of the UK's public finances is a major threat to the UK and sterling remains very vulnerable. In these circumstances, owning shares in UK companies with significant overseas business or investing in countries with better economic prospects seems a minimum requirement. In terms of getting the UK economy moving, the temporary reduction in VAT seems a very doubtful way of ensuring it.

However gloomy we may all feel, at some stage the first signs of international economic recovery will appear. We have highlighted earlier on how this may happen backed up by all the money being thrown at the situation. In due course, this could be highly inflationary, but that is for another day. The stock market is likely to anticipate this recovery.

November 2008

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