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ASSET MANAGEMENT (C.I.) LIMITED



## Investment Memorandum

Overall, this has been a good performance from international equities over the quarter and it would have been still better but for weakness right at the end because of concerns about eurozone sovereign debt as exemplified by the need to bail out Ireland. Bond yields, however, moved upwards, which is not surprising given the unattractive yield levels which have prevailed and, for weaker credits in the eurozone, there were some dramatic rises in yield. The rise in gold indicated investors' fears about paper currencies.

The tables below detail relevant movements in markets:

### International Equities 31.08.10 - 30.11.10

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+5.1	+11.8	+13.3	+10.6
Finland	+8.9	+10.0	+11.5	+8.9
France	+4.9	+6.1	+7.5	+4.9
Germany	+13.3	+14.5	+16.1	+13.3
Hong Kong, China	+15.3	+14.0	+15.5	+12.8
Italy	-2.4	-1.4	-0.1	-2.4
Japan	+8.4	+7.2	+8.6	+6.0
Netherlands	+2.2	+3.3	+4.6	+2.2
Spain	-9.1	-8.1	-6.9	-9.1
Switzerland	+2.4	+2.9	+4.2	+1.8
UK	+6.3	+6.3	+7.7	+5.1
USA	+13.3	+11.8	+13.3	+10.6
Europe ex UK	+4.4	+5.5	+6.9	+4.4
Asia Pacific ex Japan	+9.0	+12.5	+14.0	+11.3
Asia Pacific	+8.7	+10.0	+11.5	+8.8
Latin America	+8.2	+9.3	+10.8	+8.1
All World All Emerging	+8.8	+9.7	+11.1	+8.5
The World	+9.5	+9.6	+11.0	+8.4

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -2.5%

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

Currency	31.08.10	30.11.10
Sterling	2.83	3.23
US Dollar	2.48	2.81
Yen	0.98	1.20
Germany (Euro)	2.11	2.68



### **Sterling's performance during the quarter ending 30.11.10 (%)**

<b>Currency</b>	<b>Quarter Ending 30.11.10</b>
US Dollar	+1.6
Canadian Dollar	-2.3
Yen	+1.0
Euro	-1.1
Swiss Franc	+0.1
Australian dollar	-5.9

### **Other currency movements during the quarter ending 30.11.10 (%)**

<b>Currency</b>	<b>Quarter Ending 30.11.10</b>
US Dollar/Canadian Dollar	-3.8
US Dollar/Yen	-0.6
US Dollar/Euro	-2.7
Swiss Franc/Euro	-1.2
Euro/Yen	+2.1

### **Significant Commodities (US dollar terms) 31.08.10 - 30.11.10 (%)**

<b>Significant Commodities</b>	<b>31.08.10 - 30.11.10</b>
Oil	+15.1
Gold	+10.7

## **Markets**

Although equity markets performed strongly over the quarter, gains were pared back at the end of the quarter by heightened concerns over the solvency of some of the weaker eurozone countries. The Irish bailout did not stem fears of contagion. Over the quarter, the total return on the FTSE World Index in local currency terms was 9.5%, in sterling terms 9.6%, in US dollar terms 11.0% and in euro terms 8.4%. In local currency terms, The FTSE USA Index stood out with a total return of 13.3%. There were also very good performances from the FTSE Japanese Index (8.4%), the FTSE Asia Pacific ex Japan Index (9.0%), the FTSE Latin America Index (8.2%) and the FTSE All World All Emerging Markets Index (8.8%). Elsewhere, there were very satisfactory performances from the FTSE Australia Index (5.1%), the FTSE UK Index (6.3%) and the FTSE Europe ex UK Index (4.4%). In the case of the latter, Germany was outstanding, with a total return on the FTSE German Index of 13.3%, whilst, at the other end of the spectrum, the FTSE Spain Index showed a negative return of 9.1%, partly, no doubt, a measure of their relative economic positions within the eurozone. Currency movements did not generally make a significant difference to sterling returns, except in the case of Australia where the Australian dollar's strength meant that the sterling total return on the index rose to 11.8%. The return on the FTSE Asia Pacific ex Japan Index increased to 12.5% in sterling terms.

We will discuss the bond market later on, where the loss of confidence in some of the weaker eurozone credits led to a sharp increase in the respective countries' sovereign debt yields. For the mainstream high quality sovereign debt markets represented by the countries' ten year bonds, shown in the table, there was a significant uplift in yields over the quarter, albeit from very low levels. In the case of UK government bonds, the gross redemption yield rose by 40 basis points to 3.23%, for the USA by 33 basis points to 2.81%, for Japan by 22 basis points to



1.2% and for Germany by 57 basis points to 2.68%.

As the table shows, currency movements for those ones shown in our table were relatively modest this quarter, except for the Australian dollar against which sterling fell by 5.9%. Elsewhere, however, countries like Brazil and Thailand were taking active measures to try to limit inflows into their currency as liquidity in a number of western countries found its way to those countries in search of better returns.

In the commodity markets, oil rose strongly by 15.1% and gold, perhaps reflecting fears about currency debasement and inflation in future years, rose by a further 10.7%.

## **Economics**

The travails of Ireland and weaker members of the eurozone, following the earlier bailout of Greece, naturally dominate the economic headlines. A true tragedy has emerged from which Ireland will take years to recover. Those affected have every reason to be angry because this was not some “black swan” event which could not have been foreseen. Decisions, which, at the time, were obviously wrong, were made and the price is now being paid. We are all guilty of hindsight but, in this case, those who warned about policy dangers were ignored. Those in the UK who warned about the dangers of the UK joining the euro were roundly condemned, in certain circles, as eurosceptics who were somehow extreme in their views. The UK has every reason to be thankful to those individuals, from a range of political and business backgrounds, who opposed UK membership of the euro and who raised sufficient opposition to influence the last government’s decision on the question. Therefore, although the UK has very serious fiscal problems, it does, at least, have more economic tools to deal with its problems. For Ireland to join the euro might have seemed a “no brainer” given how well it had done in terms of financial support from the EU, which helped it to develop its reputation as the “Celtic Tiger”. But it was a different type of economy from that of Germany, and its profile and economic culture were quite different from those of Germany, which we are using as an example because of its position as the largest eurozone economy and the best eurozone credit. Ireland, of course, is not alone in its failure to recognise that a “one size fits all” monetary policy could not possibly work for such a disparate group of nations. One really needed one economic superstate which controlled fiscal policy as well, not a halfway house, which meant running an economy with one hand tied behind that country’s back. But that was a step too far for the politicians. Therefore, when the ECB set interest rates which were appropriate for the largest eurozone economy, Germany, there was nothing that Ireland could do about it. So interest rates were set too low for Ireland. An independent Irish central bank would surely have raised interest rates to calm the boom in property prices. As it was, cheap money fed an unsustainable property boom which the banks fuelled, bank balance sheets exploded and the banking system’s liabilities became outsized in relation to the Irish economy so that, when property prices collapsed, Ireland was staring into an abyss. It is true that there were very significant differences between Ireland and Greece. Ireland, prior to the crisis, had disciplined public finances and low public debt levels, whereas the complete opposite was true in the case of Greece. On the other hand, the size of Ireland’s bank sector relative to its economy was vastly greater so the problems of Ireland’s banks become those of the state and, if Ireland was to guarantee bank deposits, then some of the bad debts of the Irish banks become those of the state and therefore cast doubt on Ireland’s creditworthiness. A critical cause of the current economic crisis in Ireland is therefore a completely inappropriate monetary policy which had been followed and about which Ireland could do nothing because of its membership of the eurozone. As this is written, the terms of Ireland’s bailout have been announced. The total package is €85 billion. EU countries and the IMF will provide Ireland with up to this sum, which can be drawn down over up to 7 ½ years. The UK’s involvement, in various forms, will amount to up to €6.6 billion.

The creation of the euro was predicated on economic divergence. If all countries in a monetary union performed



the same economically, then a solid foundation for a monetary union existed. In the case of the eurozone, for the founder members and those which subsequently joined, this was make believe. But many investors bought it. A euro was considered to be a euro irrespective of the liability of the country in question. Looking back at the yield on ten year government bonds on the last day of trading in 2006 before the financial crisis started, Greek government bonds were trading on a gross redemption yield of 4.23% and those of Germany on 3.96%, a premium of just 27 basis points. Now, the respective figures are 11.97% and 2.68% respectively, a premium of 929 basis points. Obviously, investors have a great deal more information on the state of the Greek economy now, but, nevertheless, it is clear that investors were not correctly pricing in the risk from investing in the lesser credit and they were happy to pick up a small amount of extra yield on the basis that the holding of the Greek bond was riskless. Therein lies the current problem for the European banking system, arising from the problems of Greece and Ireland, which have received bailouts, and from other eurozone countries which may do. European banks are exposed to these problem economies. Had the banks appreciated the risk at the time, and not regarded the eurozone countries as a homogenous credit, they would have been more cautious in holding certain countries' debt.

To put this issue into perspective, the Committee of European Banking Supervisors, last July, asked 91 major banks to disclose their exposure to government debt of 30 European countries as part of their stress tests. In terms of exposure to Greek sovereign debt, it was €107.1 billion, with Greek banks heading the list. In relation to Ireland, European banks' exposure to Irish sovereign debt was €29 billion, with the biggest exposure being that of the German bank, Hypo Real Estate Holding (also a big exposure to Greek sovereign debt). In terms of exposure to Portugal, which is the next major concern, European banks held €43.4 billion of debt. In terms of Spain, the eurozone's fourth largest economy, and, judging by eurozone bond yields, a cause for concern, although not on the scale of Portugal, European banks' exposure to its sovereign debt was €256.5 billion. Going back to the end of 2006, the Spanish ten year bond yield was almost identical to that of the German one, just 4 basis points higher at 4.0%, now it is 291 basis points higher.

The point is that these are very big figures and Spain is in a different league to Greece, Ireland and Portugal, should the latter need a bailout as well. This is why the EU and ECB are desperate for the contagion to be arrested. There is not the capacity to support bailouts for a series of countries in the eurozone. Furthermore, the electorates of the relatively strong economies like Germany will not tolerate using further funds to support what they regard as irresponsibility elsewhere. The German Constitutional Court may not allow it. Although the UK is not part of the eurozone, the UK's share of the Irish bailout is estimated to be €6.6 billion, with the UK regarding Ireland as a special case because of the strong trading and banking links. In the exposures detailed in the paragraph above, after Hypo Real Estate Holding, with an enormous €10.3 billion exposure, came Royal Bank of Scotland, with a €4.8 billion exposure. UK banks are estimated to have around US\$149 billion tied up in Irish financial institutions, so the UK has a strong vested interest in trying to stabilise the Irish economy and the Irish private sector exposure is much more concerning than the sovereign debt exposure as the above figures show. This is why the EU, in its various forms, is so anxious that the Irish bailout should be successful, because it fears contagion.

Where will this all end? As we have often said, the eurozone is not an optimal currency zone and we doubt it can survive this crisis in its present form. It is self evident that, whatever happens, the outcome of this crisis is going to be very messy. If the southern European countries are going to restore their competitiveness and they cannot devalue, then they are going to have to endure a long period of savage deflation. But can these countries be made to embrace the German economic culture? Almost certainly not. Then there is the democratic element. Existing governments are likely to take the brunt of the electorate's opprobrium and there are bound to be opportunist opposition politicians who try to exploit the existing government's discomfort perhaps by offering less austerity. That is not an option for the relevant country's creditors and makes default more likely. Leaving the euro will increase a country's debt liabilities because their new currency will be weaker but a lower exchange rate will provide an economic stimulus which, at present, is not available to it. There is likely to be a limit to what the



affected electorates will endure. On the other hand, the German electorate, not having been consulted about giving up the much revered Deutschemark, is already showing signs of displeasure at having to bail out what it regards as feckless countries and this is already putting pressure on the German government. Germany might even consider leaving the eurozone. At present, this might be considered unthinkable, but it is the counterpart of weaker countries leaving it. As time goes on, there are fewer politicians around who were originally connected with the fateful decision to establish a currency union and, therefore, the embarrassment of a break up of the eurozone is less for politicians who have come after the original proponents of monetary union. How to manage the fall out in the banking system will be the issue at the forefront of politicians' minds. There are many people with a huge vested interest in the project, but even they will have to face reality. There will be many twists and turns in this story, but the unthinkable, the demise of the currency union, is no longer just that.

We need to consider how all this will play out in the markets and there are many permutations, given that events are fast moving. Our basic stance has been that, of the mainstream asset classes, equities held the most attraction and bonds the least. With regard to bonds, we see no need to change our view. Although yields on good quality ten year bonds have risen this quarter, we consider them to be unrealistically low. We can rationalise these low and previously lower yields by relating to a flight to quality after the financial crisis in 2008 and by quantitative easing in the USA and UK which, through the central banks' purchases of bonds with newly created money, pushed down yields. We are not, of course, in normal circumstances now but we are some way away from the crisis conditions of late 2008 and early 2009, so the flight to quality argument is not as strong as it was. To be satisfied with the level of yields offered on, say, the ten year bonds shown at the beginning of this review is to set very low expectations of returns. If we were likely to be in a sustained deflationary environment they could be acceptable. Equally, if other asset classes look very unappealing they could, by default, provide satisfactory relative returns. We do not see a deflationary environment in prospect even though inflation levels are low. In the UK, where inflation has been consistently above target, we see very little prospect of deflation. Until the recent move upwards in UK government bond yields, ten year gilts were offering negative real returns and, even now, yields are roughly in line with inflation as measured by the consumer price index. Cash, unless it is held for an opportunity to invest in bonds at more realistic yields, can only be for those who are extremely risk averse given that, in the UK, a rather extended period of very low short term interest rates is likely. Although equities can be expected to respond to day to day items of news (for instance, North Korean threats to South Korea), holders can be comforted by reasonable valuations in terms of earnings multiples and dividend yields. At the moment, given the overall world economic outlook, the prospect of earnings and dividend growth on an international basis gives further support. Obviously, not every company will be in this happy position. Domestically orientated companies in countries experiencing severe economic conditions in the eurozone, for example, will find conditions very difficult, but others, with good international exposure, especially to fast growing economies, can still do well wherever they are based and our client portfolios, directly or indirectly, have significant exposure to such companies.

To emphasise this point, we can look at excerpts from the October 2010 IMF World Economic Review, with its projections of economic growth for 2010 and, more importantly, 2011. As with any projections, given the fluid world economic and financial background, there is the possibility of their being blown off course by an event we cannot presently foresee, but they represent a reasonable projection, based on the evidence currently available, although events in parts of the eurozone may have a further effect in 2011. But the point is that, in parts of the world and in important areas, China, India, Brazil and the Newly Industrialised Asian economies are obvious cases in point, there is plenty of economic growth in prospect and many international companies exposed to these countries, even though they are based in a struggling domestic economy, can still benefit from these countries' economic growth rates.



Real GDP Growth (%)			
	2009 (actual) %	2010 (estimate) %	2011 (estimate) %
USA	-2.6	2.6	2.3
Eurozone	-4.1	1.7	1.5
Germany	-4.7	3.3	2.0
France	-2.5	1.6	1.6
Italy	-5.0	1.0	1.0
Japan	-5.2	2.8	1.5
UK	-4.9	1.7	2.0
Canada	-2.5	3.1	2.7
Australia	1.2	3.0	3.5
Newly Industrialised Asian Economies	-0.9	7.8	4.5
Russia	-6.5	4.3	4.6
China	9.1	10.5	9.6
India	5.7	9.7	8.4
Brazil	-0.2	7.5	4.1

Source: IMF World Economic Outlook - October 2010 (excerpt)

Whilst the eurozone is taking most of the economic attention at present because the problems of some of its members are particularly acute, this has merely diverted attention from other areas of the world. In the USA, where public finances are in a dreadful state, the mid term elections have changed the electoral arithmetic with the Republicans gaining control of the House of Representatives and the Democrats' majority in the Senate being slashed significantly. One would expect the Republicans to be more fiscally conservative but the prospect appears to be one of economic stalemate. The way the US political system works militates against any quick action to deal with the problem of runaway fiscal deficits. In the same edition of the World Economic Outlook, to which we referred above, the IMF estimated that the structural deficit in the USA's general government fiscal balance would be 8.0% this year and 7.1% next year end. Even in 2015, it would be 5.7%. These are very high levels, which have to be addressed if the US dollar is not going to hit very serious problems down the line. For the moment, it benefits from its status as the world's largest reserve currency, so that large reallocation decisions by other countries' foreign exchange reserve managers have to be tempered by the fact that such moves could be self defeating as it would affect the value of their remaining US dollar holdings. In the UK, the coalition government has set out its plans to eliminate the structural deficit over the course of the current parliament. The plans, the most ambitious of any around, have been well received in markets, but there will be stern resistance to the austerity measures which, as elsewhere, will have to be faced down if economic credibility is to be maintained. In Japan, which has an exceptionally high level of public debt as a percentage of GDP, estimated by the IMF to be 225.9% at the gross level and 120.7% at the net level this year, the immediate concern is the high value of the yen which, at the time of writing, has risen by 11.40% against the US dollar this year, by 22.44% against the euro and by 15.44% against sterling. Recent foreign exchange intervention failed and aroused anger in other countries, all of which want their currency to weaken for various reasons. Japan runs a current account surplus so there is a reason for the yen to be strong but, with its public debt level so high, strong economic growth is required and a high yen does not help. China, with its strong economic growth, has other problems, although ones which



other countries might envy. By raising bank reserve requirements, the Chinese authorities are aiming to cool the property market and restrain inflation. From time to time, the action of Chinese tightening of economic policy causes ripples in world markets, such is the economic influence which China now wields.

Inevitably, in this review, we have been concerned with the big picture events, like the eurozone's financial and economic woes, but economic life elsewhere in the world goes on, and there have been a number of items of encouraging news in certain countries, which helps to put the reasonably good performance of international stock markets into context. There is, of course, much bad news around and, so far, we have concentrated on that but, in order to give some balance, we will detail some of the items of encouraging economic news, which investors also need to consider and we will start with the USA, where the Federal Reserve recently announced another round of quantitative easing.

The main items of negative news over the last month have been in the housing market but, elsewhere, there have been a number of positive announcements. The ISM's survey of US purchasing managers in the manufacturing sector showed a rise in the index in October to 56.9 from 54.5 in September. The index for the services sector rose to 54.3 from 53.2 in September. Factory orders in September rose by 2.1% after being flat in August. The Labour Department reported a net gain of 151,000 jobs in October, caused by an increase in private sector hiring. The IBD/TIPP US optimism index rose slightly in November to 46.7 from 46.3. Although below 50, the dividing line between rising and falling confidence, the figure indicates a slight improvement in sentiment. The US trade figures were better. Although chronically in deficit, figures for September showed a slight fall in imports and a slight rise in exports, exactly the trend that is needed to sustain economic growth and reduce unemployment. Retail sales were modestly up in October by 0.4%, helped by strong car sales figures. Business inventories continued to rise, however, this time by 0.9% in September although rising inventory levels can be real two ways. Factory production in October rose by 0.5% compared with September. The Philadelphia Federal Reserve's index of US manufacturing activity rose to 22.5 in November compared with 1.0 in October, this being the best level since December 2009. The Economic Cycle Research Institute's economic prospects measure rose to a 25 week high during November. The Thomson Reuters/University of Michigan's confidence index rose from 67.7 in October to 71.6 in November. To cap it all, there was an upward revision in the estimate of US third quarter GDP growth from 2.0% to 2.5% annualised.

In the eurozone, as might be expected, there are fewer positive signs, and most of those which exist are from Germany, given its very good relative economic performance. The background to the eurozone was a reduction in the rate of growth of GDP in the third quarter which is estimated to have been 0.5% higher than in the second quarter compared with a 1% growth for the previous quarter. Year on year GDP rose 1.9%. For the eurozone as a whole, the Markit eurozone manufacturing purchasing managers index rose to 54.6 in October compared with 53.7 in September. An indicator of sentiment in the eurozone amongst consumers showed a slightly less bad figure at -9.5 in November, compared with -10.9 in October and in the EU generally at -11.1 compared with -11.5. The composite purchasing managers index for the industrial and services sector in November in the eurozone was 55.4, compared with 53.8 in October. As we say, the main items of good news, such as they were, came from Germany. The Markit purchasing managers index for the manufacturing sector stood at 56.6 in October compared with 55.1 in September. The German trade surplus, the subject of much controversy, rose to US\$16.8 billion in September compared with US\$11.5 billion the previous year. The ZEW confidence index for Germany stood at -7.2 in November, 1.8 better than in October. The German purchasing managers index for the services sector stood at 58.6 in November compared with 56.0 in October, with that for the manufacturing sector standing at 58.9 in November compared with 56.6 in September. In France, despite the social unrest, there was a slight improvement in French consumer confidence, with the index at -32 in November, compared with -34 in October. In Japan, third quarter GDP grew by 0.9% compared with the previous quarter, although life is expected to be more difficult from now onwards. In China, which is, of course, growing strongly, industrial





output in October was 13.1% higher than a year earlier. Although slightly down on the previous month's year on year rise, it still reinforced the strong growth situation in China, which is indicated in the economic forecast to which we referred earlier.

In the UK, it was confirmed that third quarter economic growth stood at 0.8% compared with the previous quarter, with the annual rate rising at 2.8%. In items of individual news which were positive, amongst all the negative items, the Markit/CIPS purchasing managers index for the manufacturing sector stood at 54.9 in October compared with 53.5 in September. The figures for the services sector were respectively 53.2 and 52.8. Private sector employers are taking on staff creating 43,000 new jobs in October, but this will, of course, be against the background of falling employment in the public sector over future years. The unemployment rate stayed at 7.7% in October with a slight fall in the number claiming unemployment benefit, down 3,700. Retail sales rose by 0.5% in October but will, in the new year, be faced with headwinds as the VAT rises. In line with this, the CBI's gauge of retail sales in early November stood at 43 compared with 36 in October, but with less optimism about the future.

In summary, the bad economic news and concerns about sovereign debt are bound to lead to some uneasy periods in markets. But, for the reasons outlined, we consider good quality equities, displaying certain characteristics such as a good international spread of business and, perhaps, an appealing dividend yield, still to be the asset of choice. Bonds remain unattractive, in our view.

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