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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equity markets have moved higher over the quarter, although sterling based investors have seen their gains pared by the strength of sterling. Bond markets have remained relatively subdued but the action has been in the foreign exchange market, with significant all round gains for the pound. Gold has endured a poor quarter.

The tables below detail relevant movements in markets :

International Equities 30.08.13 - 29.11.13

| Total Return Performances (%) | | | | |
|-------------------------------|----------------|-------|-------|-------|
| Country | Local Currency | £ | US\$ | € |
| Australia | +5.6 | +2.3 | +8.3 | +4.9 |
| Finland | +25.2 | +22.1 | +29.3 | +25.2 |
| France | +9.7 | +7.0 | +13.3 | +9.7 |
| Germany | +15.9 | +13.0 | +13.2 | +15.9 |
| Hong Kong, China | +8.5 | +2.5 | +8.5 | +5.1 |
| Italy | +14.7 | +11.8 | +18.4 | +14.7 |
| Japan | +14.8 | +3.9 | +10.1 | +6.6 |
| Netherlands | +9.5 | +6.8 | +13.1 | +9.5 |
| Spain | +20.5 | +17.5 | +24.4 | +20.5 |
| Switzerland | +6.9 | +4.1 | +10.3 | +6.8 |
| UK | +4.2 | +4.2 | +10.4 | +6.9 |
| USA | +11.0 | +4.8 | +11.0 | +7.5 |
| Europe ex UK | +11.2 | +8.2 | +14.6 | +11.0 |
| Asia Pacific ex Japan | +6.3 | +2.7 | +8.7 | +5.3 |
| Asia Pacific | +10.4 | +3.3 | +9.4 | +5.9 |
| Latin America | +7.3 | +2.6 | +8.6 | +5.2 |
| All World All Emerging | +8.8 | +3.8 | +9.9 | +6.4 |
| The World | +10.1 | +4.9 | +11.1 | +7.6 |

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +0.5%

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

| Currency | 30.08.13 | 29.11.13 |
|-----------------|-----------------|-----------------|
| Sterling | 2.79 | 2.77 |
| US Dollar | 2.76 | 2.75 |
| Yen | 0.73 | 0.61 |
| Germany (Euro) | 1.80 | 1.70 |

Sterling's performance during the quarter ending 29.11.13 (%)

| Currency | Quarter Ending 29.11.13 |
|-------------------|--------------------------------|
| US Dollar | +5.7 |
| Canadian Dollar | +6.7 |
| Yen | +10.3 |
| Euro | +2.7 |
| Swiss Franc | +2.9 |
| Australian dollar | +3.5 |

Other currency movements during the quarter ending 29.11.13 (%)

| Currency | Quarter Ending 29.11.13 |
|---------------------------|--------------------------------|
| US Dollar/Canadian Dollar | +0.9 |
| US Dollar/Yen | +4.3 |
| US Dollar/Euro | +2.9 |
| Swiss Franc/Euro | -0.2 |
| Euro/Yen | +7.3 |

Significant Commodities (US dollar terms) 30.08.13 - 29.11.13 (%)

| Currency | Quarter Ending 00.00.00 |
|-----------------|--------------------------------|
| Oil | -3.8 |
| Gold | -11.7 |

MARKETS

International equity markets have experienced a solid quarter. In local currency terms, the FTSE World Index has shown a total return of 10.1%, in sterling terms 4.9%, in US dollar terms 11.1% and in euro terms 7.6%. Looking at individual areas of the world in local currency terms, we note above average performances from the FTSE Japanese Index (+14.8%) the FTSE Europe ex UK Index (+11.2%) and the FTSE USA Index (+11.0%). The UK and Australia, whilst both showing strong performances in absolute terms, underperformed with the FTSE UK Index returning 4.2% and the FTSE Australia Index 5.6%. There was also underperformance, although to a lesser extent, from the FTSE Asia Pacific ex Japan Index (+6.3%), the FTSE Latin American Index (+7.3%) and the FTSE All World All Emerging Markets Index (+8.8%). However, because of the strength of sterling during the quarter, sterling adjusted returns, whilst pleasingly positive, are much lower, as can be seen by the difference between the local currency and sterling total returns on the FTSE World Indices. On this basis, the clear leader is the FTSE Europe ex UK Index which returned 8.2% in sterling adjusted returns. On the other hand, the FTSE Japanese Index (+3.9%) and the FTSE USA Index (+4.8%) moved to sub average performances (just) whilst the UK's performance was close to that of the FTSE World Index. The FTSE Asia Pacific ex Japan (+2.7%), the FTSE Latin American Index (+2.6%) and the FTSE All World All Emerging Markets Index all showed positive, if slightly below average, returns at 2.7%, 2.6% and 3.8% respectively.

In the ten year high quality government bond market, there was very little movement in UK and US issues. In the sterling market, the gross redemption yield on the ten year bond fell by just two basis points to 2.77% and in the US Treasury Market by one basis point to 2.75%. In the German government bond market, the yield fell by ten basis points to 1.70%. With a very aggressive loosening of Japanese monetary policy, the yield on JGBs fell by twelve basis points to 0.61%.

In the currency markets, sterling was the feature showing strong gains all round. In trying to rationalise what may seem to be a surprising development, one could link it to the unexpected strength in the UK economy which may lead to an earlier than expected tightening of monetary policy. Against the yen, sterling rose by 10.3%, against the Canadian dollar by 6.7%, against the US dollar by 5.7%, against the Australian dollar by 3.5%, against the Swiss franc by 2.9% and against the euro by 2.7%.

In the commodity markets, helping to dampen inflation, oil as measured by Brent crude fell by 3.8% in terms of a weak US dollar whilst gold fell heavily, down by 11.7%.

ECONOMICS

Whilst international equity markets have ended the quarter on a buoyant note, economic growth forecasts for the world economy are being reduced and this paradox needs explaining. In fact, it is a continuation of the phenomenon which we have mentioned many times previously which is that low bond yields (not as low as they were) and rising equity prices are largely a function of very loose monetary policy both standard (interest rates) and non standard (quantitative easing). This has had the expected effect on asset prices although the rate of increase in equity prices so far this year has surprised most commentators, even if they were bullish about equities.

To recap on the argument which we have used many times, we would say that cheap and printed money chasing a finite amount of securities (a big generalisation) will push up asset prices and this is what has happened. If we look at the UK, this has not only affected equity prices but we also see property prices on the rise, particularly in London. Companies and individuals can borrow at interest rates they never would have believed possible a few years ago encouraged by the government's various schemes to get the property market moving and to increase employment and activity in the economy. House prices are rising, too, in the USA, a very important issue given that it was the housing crisis that effectively caused the financial crisis.

The general point is that many investors who are desperate for yield can no longer find that in bank deposits, where they are getting nothing or almost nothing, and they cannot find it in good quality bonds, where yields are significantly below the norm even though inflation is low on a worldwide basis. If one takes ten year bond yields at below 3%, and they are well below that in a number of countries, one has to be pretty pessimistic to feel that they will be a good investment. It is much more likely that shares will provide a greater return. We have the situation where dividend yields in a number of important markets are above the yields on their respective government's ten year bonds and this is a very unusual situation. With short term interest rates almost certain to remain very low in the largest economies, investors have grown increasingly confident about investing in equities where they obtain a better yield. It is true that further out along the yield curve it is much more difficult for central banks to control interest rates although quantitative easing and a heavy bond buying programme can help. So there is some confidence that equities will provide a better return than cash or bonds for even conservative investors.

However, the rise in the stock markets has not been accompanied by a similar rise in corporate earnings which are fairly flat in most countries and therefore the price/earnings ratio of company shares has increased. The reciprocal of the price/earnings ratio is the earnings yield and the earnings yield is therefore well above ten year bond yields in most countries despite the expansion of earnings multiples. However, as we have often said, share price rises caused by very loose monetary policy are not considered to be of the best quality. One would like to see share price increases accompanied by significant earnings increases and this is not happening at present.

The danger of quantitative easing is that, in time, it will cause inflation to rise sharply. Once the newly created money starts circulating, and low confidence has meant that this has not generally happened, one can expect pressure on capacity in industry and services leading to higher prices. At the moment, counter intuitively, the worry is about deflation. Whilst we have all become used to being concerned about the level of inflation, deflation has really only been an issue in Japan. But falling prices create severe problems. We mention two. First of all, if the price level is falling, the real value of liabilities, such as mortgages and bank loans, increases, thus making it more difficult for these debts to be serviced and that creates a concern about the banking sector. Secondly, as has happened in Japan, if consumers, whether they be individuals or businesses, expect prices to fall, they will, rationally, delay unnecessary purchases in the expectation that they will be able to buy more cheaply in due course. That creates a vicious circle of recession. This concern may be particularly relevant to the eurozone. Because of the common currency, southern eurozone countries, in particular, have not been able to devalue their way out of the competitive disadvantages which have been building up for them since the start of the euro, although relative positions have improved. The policies imposed upon them by the troika have effectively meant an internal devaluation whereby wages, pensions and other benefits are ratcheted downwards so that the countries' costs are reduced and, in this way, the implication of the single currency is that they will have to restore their competitiveness through this vicious spiral of cost and price declines.

Apart from the social misery which this is causing in terms of obscene levels of unemployment in a number of countries, it threatens to reignite worries about sovereign debt because, if these countries move into deflation, the real value of their outstanding debt will rise thus sparking fears of further defaults and causing problems in the banking system because of banks' holdings of their respective government bonds.

Nevertheless, on a world scale, one should not be fooled about relatively low levels of inflation in the absence of action to taper, stop and ultimately reverse quantitative easing. Different countries are at different stages of quantitative easing. For example, the Bank of England has kept its limit of £375 billion but, in the USA, the Federal Reserve is still buying US\$85 billion of assets each month and, in Japan, one of the three arrows of Abenomics is extraordinarily loose monetary policy involving a huge increase in the central bank's balance sheet. Japan really has gone for bust on this.

So, if we can rationalise what has been happening to stock markets so far this year, we can say that in the absence of economic factors becoming even worse than they are already, very loose monetary policy has created some stability, particularly in the eurozone, and this has encouraged investors into what would traditionally be considered more risky assets such as equities. Investors have been prepared to pay up for equities as we can see by the price/earnings multiple expansion. Although the yields on high quality government bonds have risen significantly from extremely low levels, they still offer very poor value and some yield hungry investors have been moving into equities even if they are not the asset class which they would normally choose.

With most economies showing only modest growth and some declining, China remains absolutely key to sentiment with investors watching the growth figures very carefully. In addition, with the change in leadership, there has been uncertainty about the course of action which will be followed. The recent plenum has been completed and, from an economic point of view, investors are feeling more confident having seen the decisions in writing. The market is to have a greater importance in economic decision taking. In addition, growth is picking up even if it does not get to the double figure level that we have recently seen. So, at the moment, China is a positive factor for markets and the world economy.

What else can go wrong? Of those of which we can be fairly certain, one would be a further eruption in the eurozone. This is always possible as the fundamental flaw in the euro's structure remains. The second item, which caused markets to be uneasy during the summer, is the possibility of tapering by the Federal Reserve in terms of its quantitative easing programme although investors should be aware that printing money and buying assets on such a vast scale, as the Federal Reserve is doing, is an emergency measure for desperate times. The fact that Mr Bernanke hinted that it might occur last May set off a negative reaction in markets and hit emerging markets particularly badly. The extent of the reaction was surprising since it should have been factored in but obviously it was not. Then, when tapering was apparently delayed, perhaps because of the stand off between Congress and the President in the USA, markets recovered. This is the "bad news" is "good news" for the stock market and that definitely is not a good quality reason for a rise. But, if tapering does start soon, and this is confidently expected, it should not be seen as a bad sign for the market because it represents a very small step towards a restoration of normality even though the latter is a long way away. Tapering represents a reduction in the level of asset purchases and money printing by the Federal Reserve but does not involve it being stopped but, with inflation and unemployment two issues which the Federal Reserve will be watching, strength in the US economy would cause quantitative easing to be reduced regularly until it was stopped altogether. The final part of the return to normal policy would be the unwinding of all the quantitative easing which has taken place

and this will be difficult for markets as the Federal Reserve sells back to the private sector all the assets which it has bought, thus sucking cash out of the system and, one would expect, pushing up interest rates. This is going to be a very delicate situation and is the major issue for the market when the time comes. In the background, there is also the possibility of military conflagrations in the Middle East, although, at the time of writing, this looks less likely after the Iran deal but it is not an issue that one can easily factor into markets.

There is also the possibility of another stand off in Washington. As a result of the temporary agreement in October, the Senate and House of Representatives have to complete budget reduction negotiations by December and these must be agreed by both Houses of Congress. There is no change in the current sequestration process.

So, as we see things at the present, we still believe that equities are the best asset class in which to be invested. We are under no illusions, however, that we have taken some of next year's potential gains into this year, assuming nothing nasty happens to the market in the remaining month of the year. As we have seen with the wobble in the markets over the possibility of an early tapering of quantitative easing in the USA, the market can get rattled. We do not see shares as being expensive although they are obviously not as cheap as they were. Our best estimate at the moment is that the return next year will be modest and that there will be negative quarters but given, in our view, the enormous overvaluation of fixed interest securities and the continued negligible interest rates on deposits, the alternatives do not look attractive. The point to remember is that if bond yields return to more normal levels and these levels are significantly higher than at present, even though inflation is low, the losses will never be recovered or, if the bonds are held to redemption, the opportunity cost against holding other assets could be very high even if money is not lost in absolute terms. For shares, even if they do have a setback in value, will continue to pay dividends and, for long term investors, they can feel confident that they will recover to existing levels and move up beyond that. So we have a paradox where what were considered to be the least risky investments, such as bonds, are, in our view, more risky than the traditional assets considered more risky, i.e. equities.

Turning to look at individual areas of the world, we can start by looking at the latest economic forecast from the IMF and OECD which have both reduced their forecasts for economic growth next year. The one area which is an exception is the UK where the economic news has been consistently good in recent times. The main points from the two organisations' forecasts are, dealing first with the IMF, that it expects world economic growth this year to be 2.9% down from its July forecast of 3.2% and for next year of 3.6%, down from 3.8%. For the USA, it has trimmed its growth forecast this year to 1.6% from 1.7% and for next year to 2.6% down from 2.8%. For the eurozone, it is predicting a contraction of 0.4%, slightly better than the 0.5% contraction forecast last July whilst, for next year, its growth forecast remains unchanged at 1.0%. Japan is forecast to grow by 2.0% this year, a fraction less than the 2.1% figure forecast in July whilst next year's forecast has been raised by 0.1% to 1.2%. The one significant upgrade has been for the UK where the IMF has raised its growth forecast 0.5% to 1.4% for this year and by 0.4% to 1.9% next year. It has cut its forecast for Emerging Market and Developing Economies to 4.5% this year (5.0%) and to 5.1% next year (5.5%).

The OECD sees growth amongst its members of 1.2% for this year and 2.3% for next year. Within that total, it sees growth from the USA of 1.7% this year and 2.9% next year. In the euro area, it sees a contraction of 0.4% this year and growth of 1.0% next year. Japan is forecast to grow by 1.8% this year and 1.5% next year. For the UK, it has raised its forecast to 1.4% for this year (0.8%) and to 2.4% next year (1.5%).

In the USA, the temporary fix for the budget and debt ceiling limit from 1st October which caused a shut down for half the month has only provided short term relief as the political parties tried to agree a way forward from here. Thus, there is the ability of the politicians to spook the markets again as they have recently done. Furthermore, with the President weakened by the problems with Obamacare, which pose a serious threat to his party and has given the Republicans some hope after having come out badly from the recent stand off, political stalemate seems likely to prevail. It will be up to businesses and the individuals to keep the economy moving forward and confidence will be a key issue there.

In the eurozone, the economic figures still look very dire. Economic growth is what is needed to address the debt problem but this is in short supply. Ireland is to exit its bailout but has decided not to take up a credit line so remains vulnerable if there is any adverse turn in sentiment, although Irish bond yields suggest that investors are quite sanguine about the situation. Portugal may well need a further bail out as the Constitutional Court sometimes stymies the government's attempts to address its deficit problems. Spain has returned to very slight growth in the third quarter but not enough to address the overall level of debt whilst Italy seems to suffer from permanent political paralysis with little in the way of structural reform. Greece is testing the patience of the troika by going slow on reforms and because it has a primary budget surplus, i.e. excluding interest payments, the government has more money coming in than going out. The pressure for reform has been lessened.

But perhaps the biggest looming worry is France where the government remains spectacularly unpopular having chosen to try to address its public finance problems largely through tax increases which are meeting increasing resistance. The government is finding it very difficult to deal with public expenditure for political reasons but, with the public sector accounting for about 57% of GDP, the situation will have to be addressed at some stage if the markets do not do it for them. At present, France is able to borrow more cheaply than the UK in spite of having its credit downgraded to AA by Standard & Poors but its continued loss of competitiveness, evidenced in a current account deficit, is a worry for the eurozone. France could be the Achilles heel of the euro if serious attempts are not made to address the problem. Rising taxation acts as a brake on growth.

In Japan, there is some disappointment with the latest growth figures and the big worry is that the third arrow of Abenomics, structural reform, is proving difficult to achieve. Whilst fiscal and monetary policy can help, the vital necessity is for Japan to increase its potential long term rate of economic growth, with vigorous supply side reforms in labour and products markets, and this is something which Mr Abe has said is difficult. But, if structural reforms are not enacted, it increases the risk substantially for the economy and Japan has taken a very high risk, given its huge level gross debt as a percentage of GDP at around 250%. Japanese companies have benefited significantly from the weakness in the currency and, although the Bank of Japan's target is 2% inflation, a substantial devaluation of the yen, together with increased energy imports as a result of the nuclear power station shutdowns, means that inflation could yet be a problem. Furthermore, and this is probably very necessary, consumption tax is to rise next April by 3% from its current level of 5%. It is necessary to restore the country's finances which, in most circumstances, would be considered to be out of control and the hope is that a very stimulative monetary policy will offset the rise in consumption tax. But very low nominal interest rates mean that significantly negative real interest rates could prove a real danger to the Japanese bond market if the 2% inflation target is met. As for China, as we mentioned, the latest growth figures are mildly positive and the direction of economic thinking also appears to be encouraging. China remains a positive for international economic growth even more so because of low rates of growth elsewhere.

The UK has surprised almost everyone by the rapid improvement in its economy since the early part of the year and, in contrast to elsewhere, economic forecasts for growth are being raised. The OBR has raised its 2013 economic growth forecast to 1.4% (0.6%) and to 2.4% (1.8%) in 2014 and, thereafter 2.2%, 2.6%, 2.7% and 2.7%. This is particularly gratifying for the Chancellor who has been under great political pressure to have a Plan B. But, in truth, he has allowed automatic stabilisers in the economy to work which is why the UK is well behind its original borrowing targets announced in 2010. But the good news could be derailed by any number of factors, perhaps particularly the problems of the eurozone, a major trading partner of the UK, so there is absolutely no reason for complacency. Nearly all the indicators are looking up in the UK but it cannot be emphasised too strongly that this is from a very bad position, that borrowing remains a major problem and it will be necessary to continue the relentless pursuit of debt reduction. The issue that most concerns us about the UK at the moment is the political one in that there seems to be a concerted increase in anti business feeling stoked up by politicians which is a threat to the UK. The energy industry is a prime example with politicians of both major parties making populist pronouncements either of an energy price freeze or suggesting a windfall tax which could be a very serious threat to investment in the energy industry and bring forward the time when there will be power shortages. Politicians seem unable to realise that these pronouncements, while they may well win votes, raise the cost of capital for the industry which will mean higher prices or it will mean that investment will be curtailed. The political consensus on business seems to have broken down and investors should be concerned about this as the next election approaches in May 2015.

We talked earlier about the effects of the possibility of early tapering of quantitative easing on the stock markets and it was emerging markets that took a particular hit. Because, theoretically, tapering can be expected to lead to higher interest rates, money left emerging markets for the developed markets, pushing down their currencies, and causing stock market weakness. It was particularly bad for those countries with large current account deficits and budget deficits. Overall, we think that emerging markets will still show significantly faster growth than many of the developed economies and it would be wrong to reduce holdings in these areas even though in recent times they have been disappointing investments. A balanced portfolio is necessary and complacency certainly crept in to some of the markets with weak fundamentals on current accounts or budget deficits with structural reforms held back. Structural reforms are very necessary in these countries to improve growth prospects and investors will be watching developments closely.

As we have outlined, there are many economic challenges facing the stock markets but, for the reasons put forward, even if some of next year's share price growth has been brought forward to this year, shares remain our favoured asset class albeit that we expect uneven progress and some negative reporting periods.

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