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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

International equity markets have been steady over the last quarter but sterling investors with international portfolios have experienced adverse currency movements. Sentiment was adversely affected by economic events in Washington but the short term fix agreed just after the middle of October has, at least temporarily, calmed fears. Bond returns have been mixed, as our table shows, but currency movements have been significant as a result of sterling's somewhat surprising strength.

The tables below detail relevant movements in markets :

International Equities 31.07.13 - 31.10.13

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+9.0	+8.6	+15.0	+12.4
Finland	+24.7	+20.4	+27.6	+24.7
France	+7.8	+4.2	+10.4	+7.8
Germany	+9.2	+5.5	+11.8	+9.2
Hong Kong, China	+6.7	+0.8	+6.8	+4.3
Italy	+18.8	+14.8	+21.7	+18.8
Japan	+6.0	+0.3	+6.3	+3.8
Netherlands	+7.3	+3.7	+9.9	+7.3
Spain	+18.4	+14.4	+21.2	+18.4
Switzerland	+5.4	+2.1	+8.2	+5.7
UK	+2.6	+2.6	+8.8	+6.2
USA	+4.9	-1.0	+4.9	+2.5
Europe ex UK	+8.7	+4.9	+11.2	+8.6
Asia Pacific ex Japan	+6.6	+4.6	+10.9	+8.3
Asia Pacific	+6.4	+2.5	+8.6	+6.1
Latin America	+9.5	+4.8	+11.0	+8.5
All World All Emerging	+8.7	+3.0	+9.1	+6.6
The World	+5.9	+1.1	+7.2	+4.7

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : -0.4%

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

Currency	31.07.13	31.10.13
Sterling	2.37	2.64
US Dollar	2.67	2.56
Yen	0.80	0.60
Germany (Euro)	1.69	1.69

Sterling's performance during the quarter ending 31.10.13 (%)

Currency	Quarter Ending 31.10.13
US Dollar	+5.8
Canadian Dollar	+7.2
Yen	+5.7
Euro	+3.2
Swiss Franc	+3.1
Australian dollar	+0.2

Other currency movements during the quarter ending 30.08.13 (%)

Currency	Quarter Ending 31.10.13
US Dollar/Canadian Dollar	+1.4
US Dollar/Yen	N/C
US Dollar/Euro	-2.4
Swiss Franc/Euro	+0.2
Euro/Yen	+2.4

Significant Commodities (US dollar terms) 31.07.13 - 31.10.13 (%)

Currency	Quarter Ending 31.10.13
Oil	+1.8
Gold	+1.2

MARKETS

It has been a solid quarter for investors although, for sterling investors, currency movements have pared back gains. In total return local currency terms, the FTSE World Index returned 5.9%, in sterling terms 6.1%, in US dollar terms 7.2% and in euro terms 4.7%.

Looking at local currency returns first, all areas posted positive returns, some quite strong, notably the FTSE Europe ex UK Index (+8.7%), the FTSE Australia Index (+9.0%), the FTSE Latin American Index (+9.5%) and the FTSE All World All Emerging Markets Index (+8.7%). However, in sterling terms, the returns were quite different and, in the USA, a positive local currency total return of 4.9% turned into a negative return of 1.0%. Nevertheless, there were still above average performances in sterling terms from the FTSE Australia Index (+8.6%), the FTSE Europe ex UK Index (+4.9%), the FTSE Asia Pacific ex Japan Index (+4.6%) and the FTSE Latin America Index (+4.8%).

Government bonds, as measured by the ten year benchmark yields, were mixed. Yields dropped in Japan from 0.80% to 0.60% and in the USA from 2.67% to 2.56% and were unchanged in Germany at 1.69%. However, in the UK, the yield rose from 2.37% to 2.64%.

In the currency markets, the feature was the strength of sterling where there were strong gains except against the Australian dollar, just 0.2%. It rose by 5.8% against the US dollar, by 7.2% against the Canadian dollar, by 5.7% against the yen, by 3.2% against the euro and by 3.1% against the Swiss Franc.

In the commodity markets, there was very little change in oil as measured by Brent crude (+1.8%) and gold (+1.2%).

ECONOMICS

An eventful quarter has seen markets end up on a stronger note following the short term resolution of the stand off in the USA between the Republicans and Democrats over the budget for the year starting 1st October 2013 and for the even more important issue of raising the debt ceiling which, if not resolved, could have led to a default on US government debt. The situation is by no means resolved and further arguments may ensue in the new year when the issue is visited again. But, for the moment, markets feel a sense of relief. As a result of the tapering agreement, the US Treasury can borrow until February. The Senate and the House of Representatives have to complete budget deficit reduction negotiations by December and these must be agreed by both Houses of Congress. Meanwhile, there is no change in the current sequestration process.

Before we discuss what has just happened in the USA, it is worth dwelling on the economic forecasts from the IMF contained in its latest World Economic Outlook. Its economic growth projection for 2014 is now 3.6%, 0.2% lower than its April forecast, and 2.9% for this year, 0.3% lower. Within these forecasts, that for the USA is 2.6% for next year, 0.2% lower than its April forecast and 1.6% for this year, 0.1% lower than its April forecast. The forecast for the eurozone next year is growth of 1.0%, unchanged from April, whilst it is slightly less pessimistic for this year with the economic contraction forecast at -0.4% against the April forecast of -0.5%. Within the eurozone, it sees very

modest growth in the four largest eurozone economies next year, 1.4% for Germany, 1.0% for France, 0.7% for Italy and 0.2% for Spain. Elsewhere, it has slightly raised its growth forecast for Japan next year to 1.2% from 1.1%, whilst the biggest increases have been for the UK where the IMF has raised its growth forecast for this year by 0.5% to 1.4% and for next year by 0.4% to 1.9%. For emerging and developing economies, it is notably less optimistic. Its overall forecast for this year is a reduction in its growth estimate by 0.5% to 4.5% and, for next year, by 0.4% to 5.1%. If we look at the BRIC countries, we see the IMF forecasting growth for Brazil of 2.5% this year and next. Whilst this represents an unchanged forecast this year, it is a reduction in 0.7% for next year's forecast from last April. Russia, too, has been showing relatively low growth. The IMF has slashed its forecast for Russia this year to 1.5% growth, 1.0% lower than its April forecast and for next year to 3.0%, a reduction of 0.3%. India, too, has experienced a sharp downgrade in its growth forecasts. For this year, the cut is an enormous 1.8% to 3.8% and, for next year, a 1.1% reduction to 5.1%. Although it has reduced its forecasts for China this year and next to 7.6% and 7.3% respectively, these represent more modest reductions of 0.2% and 0.4% respectively. So, the UK stands out as a notable exception to the trend.

It is difficult for many people outside America, let alone some in America, to understand how such a crisis as the one we have just witnessed could have arisen. The roots of the problem lie in American history and the checks and balances introduced into the Constitution to ensure that no party could proceed unchecked. Whilst the checks and balances were understandable then, they are not suited to the management of a modern economy, especially with the political situation in the USA where Congress is split with the Democrats controlling the Senate and the Republicans the House of Representatives. Furthermore, politics in the USA has become much more polarised and the moderate centre is much diminished so that there is much less scope for consensus. The antipathy felt between the two parties in Congress and between the Republicans in Congress and the President is such that the stand off became inevitable and also became linked with Obamacare which came in on the 1st October and which is widely opposed in the Republican Party. Obamacare was used as a tool to try to force the President's hand to defer its implementation, but without success. The President rightly said that there were no winners in this confrontation and that there has been a cost to the US economy in terms of jobs and lost growth. But, in a continuation of the "bad news is good news" syndrome for the markets, bulls have interpreted the delay and unreliability of information and the lost growth as a result of the government shutdown being a reason for the Federal Reserve to defer tapering its Quantitative Easing programme. This had been expected in September but now many believe that it will be the new year before the Federal Reserve starts to taper. Additionally, the incoming President of the Federal Reserve, Janet Yellen, is regarded as on the dovish wing regarding monetary policy and that, therefore, there is a greater chance of tapering being delayed. However, interest rates are not her decision alone and it remains to be seen how many of the voting members of the Federal Reserve want an early implementation of tapering. For the short term, therefore, it seems likely that monetary policy will remain as loose as it has done and this has been an important reason why asset prices have risen. In some countries, share prices are at record levels and the easing back in bond yields towards the end of the quarter improved the attractions of equities. Tax rises and the effect of sequestration early this year as a result of the stand off at that time have meant that the budget deficit in the USA has been contracting so one could argue that very loose monetary policy helps to reduce the negative impact of that narrowing of the deficit on the economy. Very loose monetary policy, followed in the USA and elsewhere, represents a desperate attempt to kick start the economies in question but the probability is that quantitative easing has a steadily diminishing effect and it is unhealthy that markets are dependent upon this very loose monetary policy, standard and non standard, to move higher. A much healthier situation would be where economic growth accelerated, leading to revenue

and profits growth for companies so that profits growth did not depend upon battenning down costs. So stand offs such as we have just witnessed in the USA do not help to achieve that at all because it will have shaded a few decimal places off US growth with a slight knock on effect elsewhere in the world.

Surprisingly, in many ways, the US dollar has been very weak during the quarter as our table at the beginning of this review shows. With the US economy performing better than many others, albeit at a very modest rate, one might have expected the dollar to increase in value as expectations of early tapering and perhaps interest rate increases appearing on the horizon strengthen the currency. But what the stand off did, as we have said, is to delay tapering and, therefore, the fall in bond yields made the currency less attractive. This is the converse of the situation in the summer when the Federal Reserve floated the possibility of the start of its tapering programme. This caused money to flow back into the USA and weaken the currencies of many emerging markets causing a significant weakness in that sector. Now we see the reverse happening with these currencies recovering some of their losses and their stock markets pushing higher.

However, we must not be under any illusions that this situation is healthy. It is not. Markets and asset allocations have been hugely distorted by the widespread printing of money and, at some stage, it is important to get back to a more normal situation where we have a positive real interest rate and a winding down of money printing before it stops altogether and then is reversed as money is sucked back out of the economy as the central banks sell these assets back to the private sector. That is going to be the test case for markets and, as we saw in the summer, markets rather surprisingly took fright at the possibility of the US Federal Reserve starting to taper its quantitative easing programme. We say that it is a surprise and we should amplify this statement. Everyone knows that quantitative easing cannot last forever and that it is potentially very dangerous in terms of inflation but investors tried not to think about it and, as we saw in the first quarter of the year, prices moved ahead quite sharply in equity markets. The reaction to the possibility of tapering starting early was surprisingly negative in markets and one must hope that, having had a wake up call about this, investors will be better prepared for it when it starts to happen. We need to be clear that tapering of quantitative easing is quite different from the ending of it. It merely means that instead of purchasing US\$85 billion of assets each month, the Federal Reserve will reduce the amount that it purchases. When unemployment falls to around 7%, it may end tapering and at 6½% it may start to raise interest rates. The situation is, however, complicated by the low participation rate in the US labour market which has pushed down the unemployment rate to 7.2%. Because many people have given up looking for a job for one reason or another, leading to a low participation rate, the unemployment level is flattered. It will be interesting to see how the Federal Reserve deals with this issue because, when it gave its forward guidance on its quantitative easing policy, it probably did not envisage unemployment moving towards 7% quite so quickly but it would have been against a background of a higher employment participation rate. So the economy is not as buoyant as would be expected with unemployment at 7.2%. The minutes of the latest FOMC meeting show that it was undecided on slowing the rate of asset purchases. The latest purchasing managers indices from the USA showed manufacturing at 56.2 (55.7) and services at 55.1 (62.2), both quite well into positive territory, but we will need to see October's figures to gauge the effect of the stand off.

Wall Street, like many other markets, has enjoyed a significant rise so far this year and this is mainly the result of multiple expansion rather than earnings increases. Corporate earnings are slightly higher than a year ago and dividend increases and significant share repurchases are a feature of the market which is positive for equities but, at some stage, multiple expansion carries its own

risks and it is important that we see revenue growth in US companies. There will be some help from the current weakness of the dollar but, notwithstanding the damage done to the USA's economic reputation by recent events in Washington, we would expect the dollar to recover. With the US dollar accounting for over 60% of the world's foreign exchange reserves, it is not easy for countries to unwind their dollar holdings without damaging the value of their assets and this gives the USA a significant advantage, although it should not underestimate the damage done to its reputation by recent events.

The issues which have been at the forefront of investors' minds for a long time now remain, but the order of importance, as investors see them, changes with events. The USA's budgetary and debt ceiling issues are one factor, and this has obviously been the most important one recently, but the the problems of the eurozone remain and could come to the forefront at any time if concentration on the American problems wanes temporarily. Then there is China, an important influence on world growth given the relative strength of its economy and worries about a slowdown there. At any time, the order of importance assigned by investors to these three issues could change.

As far as the eurozone is concerned, the figures are slightly less bad than they were but there is absolutely no cause for complacency, even though politicians and eurocrats try to talk up the position of the eurozone. The debt problems of countries like Greece, Ireland, Spain, Portugal and Italy remain very serious with further bailouts likely to have to occur for Greece and Portugal whilst the French economic situation remains a serious cause of worry simply because it is the second largest eurozone economy. Although Angela Merkel's CDU and her CSU allies performed well in the recent federal election, she was just short of an overall majority and, in line with the German precedent, she will be seeking a coalition partner. The Greens have dropped out so currently the negotiations are with the SPD and these are likely to last for some time. These negotiations are likely to be difficult because some of the SPD's demands, like a national minimum wage and a financial transactions tax, do not sit well with the CDU and CSU. Although Mrs Merkel is in a very powerful position, having performed so strongly in the election, she will still have to make some compromises if another Grand Coalition is to be formed. But she does have one advantage. If talks were to break down and new elections were to be held, the SPD could suffer. Still, this introduces a big element of uncertainty into the eurozone and, whilst that is there, Germany is not likely to be generous with its cheque book to southern eurozone countries.

Mr Draghi's statement last year which, to paraphrase, says that the ECB will do what it takes to save the euro, has been remarkably successful in shaping expectations given that not one bond has been bought in the market. When real money has to be lost by eurozone countries, and this was a taboo subject in the German election campaign, things might turn nasty because the resentment in Germany and the northern eurozone countries against the size of the bailouts and the austerity which some of these creditor countries are having to face, makes them reluctant saviours of these economies. However, eurozone stock markets, like the USA, have performed very well this year and this underlines the point we have often made that it is important to distinguish between the sovereign and individual companies based in the eurozone which can perform quite differently from their own country. There are many world class multinational companies based in the eurozone which can, to a greater or lesser degree, insulate themselves from the sluggish eurozone economic performance. So the eurozone is never far from the surface. The economic news from the eurozone has been slightly less bad. For example, the purchasing managers' indices for the eurozone are both over 50 (51.3 for manufacturing and 50.9 for services). Spain, the fourth largest economy has crept into growth in the third quarter. Nevertheless, these are very early days and the fundamental

structural problems of the eurozone remain. The ECB President said that “we view this recovery as weak, fragile and uneven”. That is the correct assessment.

Then there is China. Alone of the BRIC countries, China has been performing relatively strongly, although its absolute growth rate has not been at the rate of the recent past. Of the BRIC countries, Brazil is suffering economic problems arising from low growth and an increasingly interventionist government which has also become quite protectionist. India is finding it difficult to make significant progress as a result of a power vacuum which has seen the government achieve very little in terms of reform as it faces many vested interests. Russia, too, has shown low growth and all this makes China much more important and the third quarter growth rate figures showed an acceleration over the second quarter to 7.8%. The country is trying to make a significant change in its economic profile away from fixed investment and exports towards consumption. Its banks are a concern to many because of bad debt worries. Very heavy fixed asset investment has meant overcapacity and therefore banks run the risk of bad debts as these assets are unproductive. There are hopes that the new regime will be more reform minded and, certainly, Chinese influence is increasing as we can see in the UK, an important destination for Chinese inward investment given the relatively open state of the UK economy compared with others which are more protectionist and resentful of Chinese investment. So, for the moment, after the worries in the summer about diminishing Chinese growth, there is some more optimism and this is an important issue for international equity investors. Its latest purchasing managers indices are in positive territory. That for manufacturing stands at 51.1 and non manufacturing at 55.4.

In Japan, there has been a strong stock market performance this year, but a weak currency as a result of the dramatic loosening of monetary policy and the proposed public investment programme. The weakness of the Japanese currency has helped many manufacturing companies but with a huge public debt at over 240% of GDP at the gross level, Japan cannot be complacent. It is true that most of its public debt is owned internally and therefore Japan is not so much at risk as other countries from foreigners selling their Japanese assets, but money printing on the scale that Japan is operating does pose an inflationary threat in due course. This may seem a very odd thing to say, given that deflation has been Japan’s problem, but the weakness of the yen, plus the need to import much more energy as a result of the almost complete shutdown of nuclear power stations, does threaten to cause inflation. With interest rates so low, the servicing costs of the enormous Japanese debt are manageable but, should interest rates go to much higher levels, there will be serious trouble. The policy followed by Japan is very high risk but one way to lower it is to introduce significant supply side reforms which the government is finding it difficult to do. In order to increase the potential long term rate of growth for the Japanese economy, it is necessary to remove the rigidities in the economy, particularly in terms of labour and product markets. Because of very rigid employment laws, it is difficult for Japanese companies to restructure and therefore improve their competitiveness, especially against their Asian rivals, and in the agricultural market, to give one example, very high tariffs on items like rice are purely protectionist. One way of improving a country’s debt profile is for its economic growth rate to pick up so that tax revenues improve and government spending is restrained which is why it is so important for Japan to complete the third part of Abenomics supply side reforms. These supply side reforms are particularly important, as is very loose monetary policy, in the context of the decision to raise consumption tax next April from 5% to 8% as a first step to moving to 10%, which was the original proposal for 2015. The government plans the equivalent of US\$817 billion in public works spending. As in many other countries, the combination of very loose monetary policy and tight fiscal policy is aimed at stabilising economies. When Japan raised its consumption tax in the late 1990s, it had a negative effect on the economy and this is what has caused such a significant debate about whether to go

ahead with the plan agreed by the previous government to raise the consumption tax. But so bad is the fiscal position of Japan, that it would have been a huge risk not to go ahead with it because, apart from anything else, confidence in Japan might have taken a severe hammering. For Japanese companies, the more competitive level of the yen gives them an opportunity to raise their margins and improve their profitability but, as always, they face fierce competition which is why they must operate in an economy that runs as efficiently as possible and this is why supply side reforms are so important to Japan.

In the UK, the economic news has been generally good, culminating in the IMF having to revise its forecast for the UK and to eat a certain amount of humble pie following its criticism of the government's policy last April. Although there remain huge problems in the UK, notably the level of public debt and the size of the budget deficit, most of the recent news has been positive. The triple dip recession, which was worrying economists earlier in the year, never occurred and the latest third quarter growth figures of 0.8% suggest that the economy is moving well on all fronts, albeit from a very low level. For the UK, as for other indebted countries, the best way to escape from a serious fiscal bind is for economic growth to take place and, in the case of the UK, forecasts are being raised in response to recent good economic news. Nobody is quite sure why the economy has improved as it has but it supports the government strategy of continuing to tackle the public debt levels and budget deficit. If confidence in the UK were lost because the government responded to short term political pressure to relax its efforts to reduce the deficit, then a considerable loss of confidence in the UK would be seen with very serious knock on effects. But, as we approach the time of the next general election in May 2015, political risks in the UK are increasing. What is particularly worrying is the attacks on business by politicians. This creates a very bad impression abroad and potentially damages the prospects of investments in the UK. At a time when the UK is facing a potentially very serious energy crisis, the attacks on the energy companies are particularly dangerous because they threaten to scare off investment, particularly from abroad. Anti business feeling in the UK seems to be running higher than in most countries and it increases the result of an economic accident occurring as a result of policy measures taken with the short term in mind. Investors must bear this in mind when assessing the UK. As well as the good third quarter GDP figure, the UK's purchasing managers indices are robust. The latest figures are 56.7 for manufacturing, 60.3 for services (78% of the economy) and 58.9 for construction. As a result of the strengthening economy, there are some encouraging signs on public finances. In the period from April to September, excluding exceptional items, public borrowing was £5.9 billion less than in the same period the previous year.

Our view, expressed in previous quarter this year, remains unchanged. Because earnings increases have not kept pace with the rise in share prices, equities are not as cheap as they were. Nevertheless, we think there is still value there and, for investors with a reasonably fully invested position in equities, there is sense in waiting for a setback in markets to top up equity positions. But we think equities will plot a jagged upward course. Because the rise in asset prices has been driven by cheap and printed money, the quality of the rise has not been the best and the world is still a dangerous place economically. Equities therefore remain vulnerable to items of bad news and we have witnessed this in 2013 where an upward trend in equity markets has been interrupted by the prospects of QE tapering and the recent stand off in the USA. We remain concerned that bond yields are dangerously low and, in normal circumstances, unrealistic so we would avoid this asset class. Despite the rise in the market this year, there is no room for complacency but equities remain our asset class of choice.

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