meridian

ASSET MANAGEMENT (C.I.) LIMITED

# INVESTMENT MEMORANDUM

This has been a solid quarter for international equities which have again outperformed fixed interest securities, the latter being affected by inflation and, therefore, interest rate risks, concerns about the level of many governments' borrowing levels and, now, competition from the AI hyperscalers which are borrowing unimaginable sums as they press ahead with their investments.

The tables below detail relevant movements in markets :

## International Equities 29.05.26 - 31.08.26

| **Total Return Performances ( % )** | | | | |
|---|---|---|---|---|
| **Country** | **Local Currency** | **£** | **US$** | **€** |
| Australia | +4.8 | +3.8 | +4.4 | +4.9 |
| Finland | -4.7 | -5.7 | -5.2 | -4.7 |
| France | +3.0 | +1.9 | +2.5 | +3.0 |
| Germany | +4.2 | +3.2 | +3.8 | +4.2 |
| Hong Kong | +1.4 | +0.8 | +1.4 | +1.9 |
| Italy | +5.6 | +4.5 | +5.1 | +5.6 |
| Japan | +3.6 | +2.7 | +3.3 | +3.7 |
| Netherlands | +4.4 | +3.4 | +4.0 | +4.4 |
| Spain | +11.2 | +10.1 | +10.7 | +11.2 |
| Switzerland | +5.0 | +1.0 | +1.6 | +2.0 |
| UK | +4.9 | +4.9 | +5.5 | +6.0 |
| USA | +1.9 | +1.3 | +1.9 | +2.4 |
| All World Europe ex UK | +5.2 | +3.2 | +3.8 | +4.3 |
| All World Asia Pacific ex Japan | -1.9 | -1.2 | -0.6 | -0.2 |
| All World Asia Pacific | -0.3 | N/C | +0.6 | +1.0 |
| All World Latin America | +1.4 | -0.1 | +0.5 | +1.0 |
| All World Emerging Markets | +2.3 | +1.1 | +1.7 | +2.2 |
| All World | +2.0 | +1.4 | +2.0 | +2.5 |

*Source : FTSE All World Indices*

FTSE Actuaries UK Conventional Gilts All Stocks Index (total return) : -0.8%

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

| | 29.05.26 | 31.08.26 |
|---|---|---|
| Sterling | 4.44 | 5.14 |
| US Dollar | 4.43 | 4.78 |
| Yen | 2.65 | 2.98 |
| Germany (Euro) | 2.94 | 3.32 |

## Sterling's performance during the quarter ending 31.08.26 (%)

| | Quarter Ending 31.08.26 |
|---|---|
| US Dollar | +0.7 |
| Canadian Dollar | +1.2 |
| Yen | +0.8 |
| Euro | +1.1 |
| Swiss Franc | +4.2 |
| Australian Dollar | +0.9 |

## Other currency movements during the quarter ending 31.08.26 (%)

| | Quarter Ending 31.08.26 |
|---|---|
| US Dollar / Canadian Dollar | +0.5 |
| US Dollar / Yen | +0.3 |
| US Dollar / Euro | +0.4 |
| Swiss Franc / Euro | -3.0 |
| Euro / Yen | -0.1 |

## Significant Commodities (US dollar terms) 29.05.26 - 31.08.26 (%)

| | Quarter Ending 31.08.26 |
|---|---|
| Oil | -1.6 |
| Gold | -3.1 |

## MARKETS

- International equities showed a firmer tendency over the quarter partly driven by strong corporate earnings growth.
- There were above average performances from the Europe ex UK, UK, Australian and Japanese markets whilst Asia Pacific ex Japan underperformed.
- Fixed interest markets moved in the opposite direction to equities with bond yields, as measured by ten year government benchmarks, rising significantly.
- In the foreign exchange markets, sterling moved higher. The Swiss Franc was noticeably weak.
- In the commodity markets, gold and oil ended up slightly down but masking volatility during the period.

## ECONOMICS

James Carville has earnt himself a small place in modern history. He was the political strategist who guided Bill Clinton to victory in the 1992 Presidential Election and is said to have hung a sign in the campaign headquarters with three key messages for the election team:

1. Change versus more of the same.
2. Don't forget healthcare.
3. The economy, stupid.

The first point is pure politics, feeding on frustrations against the, then, outgoing President George Bush (Senior). The second reminds everyone that outside of the Washington bubble, basic healthcare matters to people on Main Street and the third is an ear-catching turn of phrase that has entered common parlance: whilst not on everyone's lips, the primary concerns of all voters boil down to the state of the economy, especially as it wasn't in great shape at the time. His other oft-quoted adage is that "I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a .400 baseball hitter. But now I would want to come back as the bond market. You can intimidate everybody." This has figured in this memorandum on more than one occasion and those words should be hung on the walls of our political leaders' inner sanctums. Now would be a particularly good time to do so.

This month's memorandum is more focused on point 3 on Mr Carville's sign. As an aphorism it probably helped get Mr Clinton over the line and its relevance here is as a reminder to the humble investment manager that economics overarches every investment decision. Helpfully, the IMF published the latest in its timetabled series of World Economic Outlook Update economic analyses on 8th July. Before opening it, it's worth imaging the picture it might paint and then compare that with the words and figures on the page. Political tensions are higher and electorates more divided than, probably, any time in recent memory. The 'pax Americana' that has prevailed since the end of the

Second World War and has allowed international trade to flourish unhindered, appears to be coming to an end, partly at the behest of the Americans (or an American?). Countries are very heavily indebted, meaning that the option of fiscal stimulus is almost absent and the much hoped for fall in interest rates back to those indulgent levels before COVID does not seem to be on the horizon for a number of complicated reasons, largely explained by the observations immediately preceding this one. None of this, on the face of it, appears to offer the building blocks for growth and yet growth there is and the picture of growth over the last decade, excepting the short term effects of the pandemic, has been pretty consistent - far from record breaking but, more importantly, far from stagnant. It's also worth reminding ourselves of the number of risk events that have come and gone over these years yet the corporate world has adapted, lobbied, re-shaped itself and continued to grow.

As recently as April, the IMF's leading point in its World Economic Outlook was a warning of elevated risks to global financial stability caused by the ongoing war in the Middle East, potential inflationary pressures and rising risks of further tightening in financial conditions. At that time, global equity prices had fallen by 8% in two months, having been boosted by strong corporate results in the preceding months. Global sovereign bond yields had risen sharply, driven by expectations of higher inflation and spending (can you hear Mr Carville's words?) with particular concern around emerging markets with their weaker reserves of strength. To companies, higher interest rates are a drag on the bottom line as more free cash flow is consumed by debt servicing costs but, in investment terms, we worry more about the damaging effect on bond markets than on equity markets at times like these. In periods of rising inflation, especially after such a long time with historically low interest rates, the yield curve steepens, meaning the cost of borrowing for, say, 30 years becomes more expensive, relatively and absolutely, than borrowing for 2 years. This has led to more issuance of short dated bonds, for logical reasons, which adds to the level of risk in the market where the supply of such paper is increased at a time when price sensitive buyers are scrutinising every development.

It is the job of the IMF, and others, to draw attention to the short term weather inevitably created by politics and weather is on a lot of people's minds at present. To the investment manager it is more a question of whether events on the global stage, brief or protracted, risk causing a long term head wind to the progress of the companies in which we invest on behalf of clients. The Global Financial Crisis caused a large step up in debt creation to bail out financial institutions but the policy response from central banks through quantitative easing and other programmes was to suppress interest rates to, in effect, subsidise borrowers and to encourage animal spirits. The policy was successful but the pandemic came at an unwelcome time as it increased indebtedness by an even larger amount as the State funded an economic holiday. The combined effect of these two, as well as the policies of profligate governments who seem content to borrow from the future, takes us to the point we find ourselves at in national finances where the volatility in bond markets reflects the delicate position that even so-called risk free borrowers can find themselves in.

Now, rolling on to the July update from the IMF, the acute risks that were associated with the conflict in the Middle East in March seem slightly more diluted but susceptible to change at any moment. The conflict remains completely unresolved but the explosive energy of the initial waves of bombing seems to have dissipated somewhat. The price of crude serves as a barometer of 'progress' and it is possible that Iran feels empowered by everything that has happened. It has demonstrated a level of control over maritime traffic in its coastal waters and enjoyed the effects that result and the government appears to believe that its pain threshold is higher than President Trump's. Regime change, if that were ever a target, has not been achieved though the effect on the popularity of the regime is hard to gauge. A phrase which resonates at this time is that Iran lost the war but won the negotiation but to the average Iranian, inflation is rampant, shortages abound and, now more than ever, they must question why they are not living in a wealthy petrostate. The tactic of prolongation by Iran does not help either President Trump's popularity at home nor the prospects for his fellow Republicans in the November mid-term elections.

Is any of this relevant to the economic memorandum or Meridian's investment decision making? In many ways, no. Through the first two quarters of the year, equity markets are strongly up, our disfavour of bonds has increased and inflation expectations rose, fell and, at the end of August, rose again. The spectre of rate rises re-emerges. This is not as helpful as the pre-conflict cuts that were forecast at the start of the year but the resilience that markets have shown reflects, more than anything, reported results in the first quarter, especially from U.S. companies and forecasting that is more bullish than might have been expected a few months ago. The AI boom, where the tech titans have spent unimaginable amounts of their cash stockpiles on data centre infrastructure has provided an economic stimulus at a good time and the suppliers to those companies - those in grid infrastructure, chip manufacturers and data centre builders, amongst many others, are seeing their part of the windfall spending reflected in higher share prices; Samsung Electronics reported on 7th July a 19 fold increase in second quarter operating profit against the same period a year earlier. Its share price has rocketed but it's worth noting that the Bloomberg estimated price/earnings ratio of Samsung Electronics is now at its lowest compared with the MSCI World Index price/earnings ratio since records began.

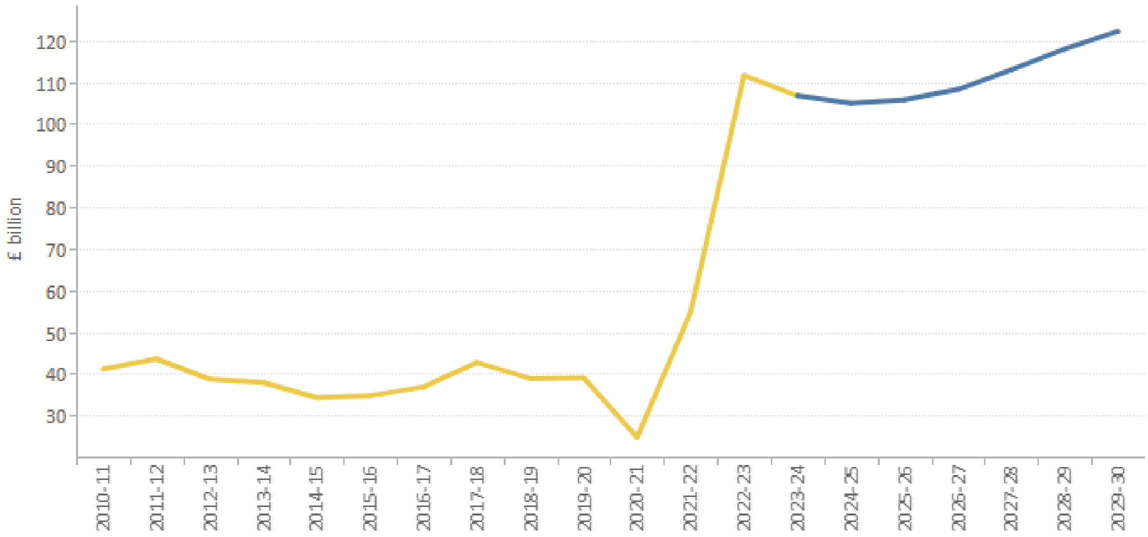
Whilst on the conversation about current profitability, South Korea's Labour Minister, Kim Young-hoon is leading calls for tech giants to distribute their AI-driven memory chip profits as a means of narrowing economic inequality and there are also choices to be made at the state level to allocate the windfall corporation taxes received from Samsung Electronics and its rival SK Hynix. The third major player in this sector is the American company Micron Technology. Windfall taxes, to many politicians, seem too attractive to resist as large parts of the electorate see them as only a good thing. In the UK we had windfall taxes on oil companies in 2022 when the Russian invasion of Ukraine caused prices to spike. These were introduced by the last administration and expanded under the current administration and are due to run until 2030 with the overall headline rate of taxation for North Sea oil and gas activities now 78%, according to the BBC. Spain introduced a windfall tax on its largest banks in 2022, described as a temporary measure, it will now continue until at least 2027. Meridian would not be a supporter of such taxes and the current South Korean example can be used to explain why. Chip manufacturing is expensive and demands a great amount of investment. Counterintuitively, it is a cyclical business with prices fluctuating greatly through the cycle. As recently as 2023, Micron Technology was making losses but increased its debt levels, at a time of rising interest rates, to increase manufacturing capacity. AI hyperscalers are now scrambling to buy all available high bandwidth memory chips which are needed for their data centres. They appear insensitive to price and gross margin on these chips is very high, possibly as much as 85%. Windfall taxes are likely to disincentivise further investment, both by the current market participants and new entrants and if applied to chip makers then why not to all the other suppliers to AI who are enjoying huge uplifts in profit? Is it helpful saying to companies that in fallow years you must suffer your losses but in good years your profits will be capped? It takes a minimum of two years to build a new facility and Samsung Electronics and SK Hynix's share prices fell on 29th June when they unveiled at a Presidential briefing in Seoul combined spending packages worth $1.3 trillion. That expansion is welcome as a real world investment that creates jobs and will facilitate the progression of AI but windfall taxes are a barrier in the way to such expansion. An unintended consequence of these extraordinary AI-driven profits is that non-AI customers are now signing up to three year programmes of purchase which should flatten demand and, hence, pricing, in the market. Ford and General Motors are two such companies that have committed to deals with Micron Technology. These are termed 'take or pay' contracts that strengthen the suppliers' hand with stable long term revenue commitments rather than unpredictable spot pricing.

America's recent history shows a number of occasions when Congressmen have proposed windfall taxes, usually on oil and gas companies, but they inevitably face overwhelming opposition and do not make it into law. There has not been any suggestion that Micron Technology will be hit with any windfall tax in its home country but it was granted $6.4 billion of Biden-era government subsidies to help cover the cost of building new production sites in the US, along with a 35% investment tax credit. Under the terms of the CHIPS and Science Act it looks like it will have to repay 75% as a consequence of its vastly improved profitability. The Act states that the repayments are not channelled into general government reserves but must be reinvested directly back into the CHIPS Act program to support the domestic semiconductor ecosystem. That all seems perfectly reasonable given the company is forecast to make around $175 billion in profit next year.

There are two points to distil from the previous paragraph. The extraordinary ambition of the AI leaders such as Nvidia has been rewarded with extraordinary growth in their valuations and the money that they are spending is now being reflected in the valuations of their many suppliers. The question is whether these are short term, sugar rush surges in revenue or whether those supplier companies have been catapulted upwards and will continue to operate on this new plane of profitability. In the case of Samsung Electronics, the jury would appear to be out. Its share price is currently around three times higher than its 2025 average but, as mentioned above, it is by one measure, a very cheap stock compared with its history. The second point relates to the disinclination of the US to apply windfall taxes and the Meridian view is that this is indicative of a level of pro-business support that is, unfortunately, not mirrored in other countries, particularly those close to home.

Raising levels of taxation reflects a financial need, which is to meet the costs of running a country and to manage the cost of the accumulated debt burden of the sovereign state, but the application of tax policy is very political. Any government will have ideological values, though there can be a surprising level of fluidity (or pragmatism) in some politicians in their adherence to their values and then there is the issue of doing what is right and then getting re-elected afterwards. Those flexible values can sometimes mean the latter is prioritised over the former.

Heavily indebted countries, and here we include the United States with UK, France, Italy and Japan, amongst many others, have ever more limited options as the cost of servicing debt rises. This graph from the UK's Office of Budget Responsibility shows the cost to the government of servicing the national debt, with the blue continuation being forecast amounts.




Source: HMT, OBR

In considering the position of the UK, which is far from unique but is more familiar to most readers, the tax burden on companies has increased markedly. Individuals vote and companies don't and to a cynical mind, that could be a factor, but companies employ and invest and can choose to increase, maintain or reduce levels of both. The OECD estimates that services account for around 80% of the UK economy, compared with an average of around 70% for other OECD member countries. A hotel or a hairdressers will not have any choice about its location but HSBC, Compass Group (world's largest contract food service business, employing 590,000 with $46 billion in annual revenue and headquartered in Chertsey) or a call centre operator could choose to leave UK or prioritise business elsewhere. A feature of the London Stock Exchange in the last couple of years has been the number of companies that have been bought, usually taken private, usually by private equity firms and usually American ones. This is because the UK market offers attractive valuations or put another way the stocks look cheap. Easyjet, Tate & Lyle, Intertek, Spectris, Darktrace are all multi-billion pound businesses that are leaving the London market and the implication is that being a UK-based company detracts from the marketability of its stock. The total value of all of the companies listed on the London Stock Exchange is now less than the value of Nvidia, Apple and Alphabet - not collectively but individually.

Division is, unfortunately, becoming more of a feature of contemporary life and a simple measure of this is the rise of new, alternative political parties and movements in many countries. Within this, a populism can develop which includes a negative view on what companies stand for and this, in extremis, risks embedding itself in the national psyche. At one extreme, companies are innovative wealth creators that contribute to ever improving living standards whilst to some, they are parasitic, amoral and purely self-serving. From the companies' perspective, the response to hostile politics becomes a decision around where to do business. Ireland has been very successful, the United Kingdom less so. The United States, reflected by its buoyant stock market, has a history of making good decisions in this area and, for all of his faults, President Trump has, largely, continued this trend of support.

There is a good chance that everyone reading this will understand the risks and rewards of owning equities. Ultimately, the return on capital invested is a factor of profit which boils down to income versus costs. Costs are financial and include taxation but regulation, bureaucracy and uncertainty are less defined in the accounts but are reflected in the share price. In this month's economic memorandum the focus is on tax and intangibles, not because they are the single most important consideration when deciding how to invest client monies but they are a factor and the sometimes belligerent and confrontational methods currently employed by the US Executive belie an intention of support. Where permitted by mandate we continue to have a relatively high exposure to US companies and remain comfortable with it. Global economic conditions that prevail are reasonable to slightly favourable, in historic terms, and we continue to advise clients to prepare for negative quarters but to look beyond the news headlines which are, in the main, quite depressing. The asset class remains attractive and inflation beating returns over the medium to longer term are very realistic.