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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

The performance of the world economy stands in stark contrast to the performance of international equity markets, as the table below shows. In our review, we seek to explain why this has happened and look forward to the longer term implications of the pandemic for the world economy and securities' markets.

International Equities 29.05.20 - 31.08.20

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+5.5	+9.3	+18.4	+10.1
Finland	+10.9	+10.1	+19.2	+10.9
France	+6.5	+5.7	+14.5	+6.5
Germany	+10.5	+9.7	+18.8	+10.5
Hong Kong, China	+19.9	+10.7	+19.9	+11.5
Italy	+8.3	+7.5	+16.4	+8.3
Japan	+4.0	-2.4	+5.7	-1.7
Netherlands	+7.3	+6.5	+15.4	+7.3
Spain	-0.7	-1.4	+6.8	-0.7
Switzerland	+2.9	+1.4	+9.8	+2.2
UK	-0.9	-0.9	+7.3	-0.2
USA	+16.4	+7.5	+16.4	+8.3
All World Europe ex UK	+6.4	+5.3	+14.1	+6.1
All World Asia Pacific ex Japan	+17.8	+12.0	+21.3	+12.8
All World Asia Pacific	+12.5	+6.4	+15.3	+7.2
All World Latin America	+10.4	+1.7	+10.1	+2.4
All World All Emerging Markets	+18.5	+10.5	+19.7	+11.3
All World	+13.1	+6.5	+15.3	+7.3

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -2.8%

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

Currency	29.05.20	31.08.20
Sterling	0.18	0.31
US Dollar	0.66	0.71
Yen	-0.07	0.04
Germany (Euro)	-0.45	-0.40

Sterling's performance during the quarter ending 31.08.20 (%)

Currency	Quarter Ending 31.08.20
US Dollar	+8.5
Canadian Dollar	+2.5
Yen	+6.6
Euro	+0.9
Swiss Franc	+2.0
Australian Dollar	-2.3

Other currency movements during the quarter ending 31.08.20 (%)

Currency	Quarter Ending 31.08.20
US Dollar / Canadian Dollar	-5.5
US Dollar / Yen	-1.8
US Dollar / Euro	-7.1
Swiss Franc / Euro	-1.0
Euro / Yen	+5.6

Significant Commodities (US dollar terms) 29.05.20 - 31.08.20 (%)

Currency	Quarter Ending 31.08.20
Oil	+28.3
Gold	+14.0

MARKETS

Provided an investor had a well diversified portfolio geographically, the latest quarter has been a satisfactory one. In local currency and total return terms, the FTSE All World Index returned +13.1%, in sterling terms +6.5%, in US dollar terms +15.3% and, in euro terms, +7.3%. Looking at local currency returns first, the outstanding performance came from the FTSE All World All Emerging Markets Index which returned +18.5%, the FTSE All World Asia Pacific ex Japan Index which returned +17.8% and the FTSE USA Index which returned +16.4%. The most disappointing performance came from the FTSE UK index which returned -0.9%. The FTSE All World Europe ex UK Index, whilst providing a very satisfactory return of +6.4%, was well below the average local currency return. However, the picture looks quite different when we examine the total returns in sterling terms. The returns on the FTSE All World All Emerging Markets Index and the FTSE All World Asia Pacific ex Japan Index at +10.5% and +12.0% respectively are still excellent, whilst the substantial reduction in the FTSE USA Index performance to a still very good +7.5% is still a notable difference. The FTSE Japan Index moved into negative territory in sterling terms at -2.4%. On the other side of the story is the FTSE Australia Index, where a local currency total return of +5.5% becomes a very substantial +9.3% in sterling terms.

Looking at the international fixed interest market, as measured by ten year government bonds, there has been a modest upward movement in gross redemption yields. For the sterling government bond, the yield has risen by 13 basis points to 0.31%, for the US Treasury bond by 5 basis points to 0.71%, for the Japanese Government Bond by 11 basis points to 0.04% and, for the German Bund, the negative yield has declined by 5 basis points to 0.40%.

As the difference in equity index returns between those in local currency and sterling implies, there have been some significant currency movements over the last quarter with the US dollar being noticeably weak. Against the US dollar, sterling has risen by 8.5%, against the yen by 6.6%, against the Canadian dollar by 2.5%, against the Swiss Franc by 2.0% and against the euro by 0.9%. However, against the Australian dollar, sterling fell by 2.3%.

In the commodity markets, oil, as measured by Brent crude, rose by 28.5% and gold, seen as a store of value in troubled times, rose by 14.0%, although it is off its peak.

ECONOMICS

With international equity markets standing at around all time highs, many people might be scratching their heads and wondering how this can possibly be given the enormous economic damage caused by the coronavirus pandemic. In the most simple terms, it is the effect of the enormous fiscal and monetary stimulus provided by governments and central banks throughout the world which has had the effect of suppressing interest rates and supporting demand, even though the latter is weak in many sectors of the economy particularly affected by the pandemic.

Central banks' monetary policy almost everywhere has been exceptionally loose. In terms of interest rates, either through administered policy (i.e. official rates) or market intervention (aiming to control interest rates so that they stand at targeted levels through bond market purchases), they continue to stand at levels hitherto believed impossible, including being in negative territory. This is a policy started in the Global Financial Crisis and, although there have been attempts during the intervening twelve years to make a move towards normality, notably in the USA, it never got very far and has now been reversed in the light of the pandemic.

An instant reaction for many people might be that very low or negative interest rates are very good news. Whilst that is the case for some people and businesses, i.e. borrowers, it is not the case that this is true of the whole economy. Savers are one example. Many people, especially those who are retired, need the income to live off. Now they are effectively denied any meaningful interest on their deposits. They might also be invested in fixed interest securities but, here too, if invested in high quality issues, returns are derisory. As the table at the beginning of this review shows, yields on high quality bonds are either very small, the UK, USA and Japan, or negative, Germany and Japan, if measured by ten year government bonds. Given how long the world has been living with ultra low interest rates (since the Global Financial Crisis twelve years ago), these ultra low or negative interest rates may seem to be the "new normal". That is not a desirable state of affairs for a number of reasons. One is that it encourages risk taking in search of higher returns and, with higher indicated returns, comes added risks. One only has to read the Personal Money pages of the weekend press to see how investors in some products offering, on paper, attractive returns have found that the investments did not turn out as expected or, in some cases, are scams. When price signalling (in this case interest rates) is suppressed, economic and investment distortions occur. For example, less than creditworthy companies may be able to borrow at unrealistically low interest rates because of interest rate suppression. Investors attracted by the yield, which will be higher than on good quality issues, may therefore be exposing themselves to risk. Money may also leak into speculative assets, creating a financial risk, or into property, perhaps creating a bubble. As property is susceptible to political interference, such as making buy-to-let less attractive for investors, which has happened, investors could find their returns compromised. Low interest servicing costs mean that companies, which would otherwise go out of business, survive, helping to crowd out the market for companies with better growth potential. This damages the wider economy by reducing its potential growth rate.

This enormous fiscal and monetary stimulus is a major reason why international equities are now standing at around record levels. The money created by quantitative easing and the enormous increase in the size of central banks' balance sheets has leaked into shares and has driven prices higher so that, overall, they have recovered their best levels. Markets look ahead and, in the special investment memorandum which we sent to clients in early March, when the markets were falling heavily, we emphasised that it was important to anticipate what governments and central banks might do. It was obvious that they would prime the economic pump and that was what investors needed to concentrate on at the time. It is understandable that investors were fearful and loose holders or those forced to sell, perhaps because they were overleveraged, have suffered, so far at least, large opportunity cost losses. Normally, investors would be able to anticipate a downturn, perhaps because economic policy was being tightened, but this was a "black swan" event and investors did not have time to adjust their positions beforehand. As a result of the suddenness of this pandemic hitting hard so quickly, the stock market fell heavily over a very short time. For long term investors, happy with equity risk, it was always important to look ahead to the time when the news on the coronavirus would become less bad and to the actions which the authorities would take to try to stabilise the position. It is trends which are important which is why those who, understandably, were influenced by the news background and the inevitable media emphasis on the negative, may have been influenced by and acted upon the present position rather than looking ahead to the policy reaction and the effect this might have on markets.

So, if we look at three asset classes, high quality fixed interest, equities and cash, we see the historically unusual situation where the highest yield is provided by equities. Traditionally, of course, equities have been bought for capital appreciation, whilst fixed interest investments and cash have been held mainly for income. Clearly, some investors have moved into equities in order to receive some income, even after the dividend cuts, and thereby varied their risk profile. It is important here to reflect upon the meaning of risk in the context of what we were discussing earlier, namely the danger to investors of purchasing more risky bonds or other assets offering “too good to be true” returns. The danger here is one of capital loss if the asset defaults. The other risk is of a rise in interest rates which will cause a capital loss in the bonds, however good the quality, unless at the very short end of the market. Because interest rates are so far from normal, any reversion to mean will have a significant adverse effect on the price of fixed interest securities. So the risk from holding fixed interest securities could be qualitative if the issuer defaults (chasing high yield) or a capital loss resulting from the adverse effect on bond prices if interest rates rise. Assuming good quality equities are bought, the risk should generally not be qualitative but one of a fall in value. But, given the long term performance of equities, the chances are that a fall in the equity market will be more than recovered. This may not be the position with fixed interest securities, so the traditional asset which is considered less risky, fixed interest, may turn out to be more risky because of the way in which interest rates have been distorted.

This begs another question. Can an investor ever be satisfied, other than in the short term, with a yield on a fixed interest security of, say, -1.0% to +1.0%, which covers the range of most 10 year government bonds? Even with inflation levels currently so low, mostly below 1% in developed economies, current yields cannot possibly meet investors’ long term aspirations. This leads on to another question, as to whether the current interest rate scenario is becoming the “new normal”. The longer this period of ultra low or negative short term interest rates continues, the more it will seem to be the normal situation. If that should be the case, then the current ratings of equities, despite the cuts to profits and dividends caused by the economic shutdown, could reasonably be argued to be justified. We mentioned the yield advantage earlier but, if one considers that the net present value of a company reflects future earnings and cash flows, then the ultra low interest rate that one uses as a discount rate raises the net present value and justifies a higher level of share prices. In this model the level of the discount rate is crucial. For those investors comfortable with the present level of the international equity markets, this argument plus the relative yield attractions of equities is important.

Should we accept that the current level of interest rates represents the new normal? Certainly for the foreseeable future, interest rates will remain roughly where they are now. Although there are signs of economic recovery, the world economy remains in a depressed state and a tightening of monetary and fiscal policy would seem to be out of the question, especially if there were to be a second wave of the pandemic. However, debt levels are soaring. Whilst interest rates are where they are, servicing costs are generally manageable but, when interest rates start to rise, there will be a problem for many countries, leading to credit rating downgrades and some financing issues. So, one may ask why can’t central banks keep interest rates where they are and keep printing money through quantitative easing and why can’t governments keep spending money to support their economies until some semblance of normality returns? One argument, not shared by everyone these days, is that if central banks keep printing money to buy assets in the secondary market, their already bloated balance sheets will lead to inflation. Banks will lend more as confidence increases and, with supply constraints, extra demand created by this money circulating faster around the economy will cause inflation. In some ways, it is surprising that inflation has been as quiescent as it has been prior to the lockdown, but it does not mean that, when there is a return to a different sort of normality, inflation will not appear. If it does, it is likely to be a spur to central banks to start to raise interest rates. As to why governments cannot continue to run large budget deficits indefinitely, with central banks effectively (although not in strict terms) financing these deficits, the answer lies partly in confidence which, if lost, manifests itself in a sinking currency and, therefore, rising inflation and, at the other end of the scale, one sees what

happened to Venezuela and Zimbabwe when the printing presses have been turned on. At the moment, it might seem a zero sum game, with all the major developed countries' central banks involved in quantitative easing, but a weak link is likely to develop amongst them at some stage. Central banks are not supposed to finance governments directly, but what is happening at present reflects a fine line between primary and secondary financing. Central banks buy assets in the secondary market from purchasers in the primary market who know that they will be able to sell their bonds on. However, it is not a given that investors will accept this increasing level of debt indefinitely and be happy to finance it in the primary market. Once the immediate issue of subduing the pandemic is dealt with and, hopefully, a vaccine found, governments around the world will have to address their severely impaired finances. In the meantime, although economies are recovering as more people return to work and output is increasing, they are nowhere back to normal, with some sectors like leisure and transport still in severe difficulty. This makes the tightening of economic policy almost impossible. Should there be a second wave of the coronavirus, and there are some disturbing increases in cases in some countries, governments will be faced with an acute dilemma. Shutting down vast sections of an economy again is almost unthinkable, so, in the absence of a vaccine, it is likely that economies will have to work round the problem. It is an invidious trade off between the economic and health consequences. It is no wonder that, when there is some optimism expressed about the possibility of a successful vaccine, the stock market tends to move higher. There could be no better news on the health front than the discovery of a vaccine which works and, behind that, as health issues are paramount, on the economic front too. In the latter case, if it was safe for everyone to go to work and to travel, that would provide the path for governments to address their own countries' financial danger. That will be an incredibly difficult task and politically very unpopular decisions will have to be made. The alternative, namely putting off unpopular decisions, will risk a collapse in confidence in the creditworthiness of countries, with the dire consequences which would follow from that. So, our best estimate is that, whilst governments are trying to deal with the consequences of the initial pandemic and have to borrow heavily to do that, the markets will accept this, but investors' patience will not last indefinitely if the running of large public deficits and the resulting large borrowing requirement become a way of life, with governments not prepared to take the steps to address the danger to their countries' balance sheet and international credibility.

Whilst it is clear that, for medium and long term investors, fixed interest securities provide no value at all and contain a significant risk to capital values as and when interest rates revert to mean, the situation is not so clear cut for equities. As we discussed earlier, the current level of interest rates is supportive for equities, even though they may be highly valued on historical grounds and when many companies' profits and dividends are being affected by the severe recession which the pandemic has caused. Investors, however, have to invest on the basis that, in the long term, their assets will grow in value. Ignoring property and gold, out of fixed interest securities, cash and equities, only the latter on current metrics can realistically provide this. If we do, for reasons given earlier, enter an inflationary environment, hard though it is to believe it at present, then holding a stake in real assets through shares is likely to be the correct option to preserve value. For the sceptical investors who are now being dragged into the equity markets for fear of missing out on the rally since 23rd March, they might view equities as the least bad option. For us, it is difficult to see a timeline that would make fixed interest securities attractive for those who have a choice as to which asset they can invest in, and we would therefore make a more positive case for equities, a view which is reflected in the composition of our clients' portfolios.

That is the broad picture, but there are many underlying nuances in the international equity markets' performances this year, mainly as a result of the coronavirus pandemic. Overall, since the beginning of the year, international equity markets are modestly higher but, within this movement, have been enormous variations in performances. The stand out markets on the positive side have been China, the USA, driven by a substantial rise in the NASDAQ index and, therefore, technology stocks, Germany, Sweden and Switzerland. On the negative side, have been the UK and Spain. The very wide dispersion of performances shows how important geographical and sector asset allocation is. If an investor had held an international equity portfolio broadly reflecting one of the world indices, the year

to date performance would not be far from unchanged. If a sterling based investor had succumbed to home bias by holding a significantly overweight position in the UK, returns would have been negative. This has been a significantly larger than usual dispersion of performances in international stock markets so far this year, but it does make the point as to how important it is that portfolios are diversified. The UK now represents not much more than 4% of the FTSE All World Index, so a significantly overweighted position this year has been painful. The US weighting is around thirteen times higher and when there is around a 23% difference between the performance of the world market and the UK one in sterling terms for the year to date, it makes a big difference.

This logically leads on to why there has been such a difference in performance between different markets so far this year which ties in with what will be the longer term implications of the pandemic for the economy and stock markets.

To illustrate what has happened so far this year, it is worth comparing the US stock market with that of the UK. The first important point to make is that no one expected a coronavirus pandemic at the beginning of the year. The UK had had a general election in December which had produced a clear result and a lot of uncertainty had been removed. Whilst Brexit still loomed, to us the result of the general election was more relevant, given the enormous policy differences between the two main political parties. The UK equity market was one of the highest yielding ones and there was little doubt about the dividend paying potential of UK shares, notwithstanding a decline in the level of dividend cover. There was also a feeling in some quarters that a recovery in value stocks, of which the UK has plenty, was overdue, given the long period of outperformance by growth stocks. So, whereas the UK was heavy in energy, mining, banks and insurance shares, the US was heavy in the technology sector.

Come the economic shutdown, the profile of the UK stock market was unhelpful. Under the impact of a collapse in demand, the oil price fell sharply. The two largest UK oil companies, Royal Dutch Shell and BP, cut their dividends, not something that was anticipated before the coronavirus pandemic. The banks were told not to pay dividends and there was pressure placed on the insurance companies to halt their payouts. On the other hand, many technology companies have had a good pandemic, with an enormous increase in the demand for their services as many people moved to working from home. This sector has gone from strength to strength, as the performance of the NASDAQ index shows. The UK market has fallen out of favour because it has very few technology companies where the US market has plenty. In the US, S&P 500 Index, sectors such as internet, software, computers and semiconductors, account for about 36% of the index. Out of this, Apple Inc., Microsoft Corporation, Amazon.com Inc., Facebook Inc. and Alphabet Inc., owner of Google, account for almost a quarter of the index. The FTSE 100 has nothing like this, the biggest sector being pharmaceuticals at about 12% of the index. At the beginning of the year, before the coronavirus news was known, one might reasonably have expected the value stocks in the index to perform well on the back of attractive yields, compared to what was available elsewhere. Now, if we look at the top ten stocks in the index, we see that HSBC Holdings has omitted its dividend, not of its own choice but under regulatory diktat, and BP and Royal Dutch Shell have cut their dividends. This means that the dividend yield on the FTSE 100 index might begin with a “3” rather than perhaps a “5”.

Many things will change as a result of the fall out from the pandemic, some of which might seem obvious now and others which will become apparent later on and may be completely unexpected. Perhaps the two most obvious are an increasing tendency to work at home even in normal times and the further advance of online shopping. The technology sector has benefited from the increased working from home during the pandemic and this trend looks to continue. Obviously, it is not a homogenous sector, so some will benefit more than others, but the trend is clear. Perhaps the biggest cloud hanging over the sector is political. The technology companies have a lot of enemies and there may be attempts to break them up, particularly if the Democrats gain control of both arms of Congress and the White House. For the moment, investors appear to be ignoring this possibility. If more people work from home on a permanent basis, there will be negative implications for areas of the commercial property market, transport companies and restaurants with a large business clientele in the big cities and hotels.

With video conferencing having exploded in use during lockdown, companies looking to save on their travel bill will reduce staff travel with knock on effects on the already very troubled airline industry. The retail sector was already in trouble before the pandemic. This looks to worsen as the move to online shopping intensifies. This spells more trouble for retail landlords but, conversely, improves the prospects of the already flourishing industrial property sector where large warehouses have been required for delivery centres.

Whilst growth stocks have had a strong run relative to value stocks for a long time now, the divergence, which was strong before the coronavirus, has become even stronger during the pandemic, but it does not mean that we should extrapolate trends, so it is worth asking the question as to whether the value stocks can make a comeback in the foreseeable future.

If we look at the oil sector, an important source of income for many, the shutting down of parts of the world economy led to a collapse in demand and a resulting collapse of the oil price although there has been a partial recovery. As the world economy recovers, demand should pick up, too. However, the effect on prices will also be determined by the supply position and whether the oil producers can maintain discipline on output trends. But market forces will also play a part. For many shale oil producers, current prices are painful, so some will withdraw, strengthening the position of those who remain. At the same time, the oil majors are turning their attention to green energy. Whilst Royal Dutch Shell and BP in the UK have cut their dividends, the two US oil giants, Exxon Mobil and Chevron, have not so far, and respective gross yields of 8.7% and 6.1% do look out of place in a yield starved world. Neither has given an indication that it plans to cut its dividend in the immediate future, despite such difficult trading conditions as they are currently experiencing. At least the UK oil majors continue to pay dividends which the banks do not, having been ordered to stop them by the regulator. At present, this gives them the equivalent of quasi nationalised status and, without a dividend yield, prices have fallen sharply so that they stand at a significant discount to book value, with the highest rate being HSBC at about 0.53 times. Freed from regulatory diktat, given their improved capital position going into this crisis compared with the Global Financial Crisis, one would expect them to resume some level of payment when they are permitted to, although lower than pre-crisis. Banks have become so political that there is a significant amount of uncertainty around. One bank which will be particularly anxious to resume payments is HSBC because, apart from Asia dominating its business, it has a lot of Asian shareholders who rely on it for income, as do UK shareholders. Banks have had to make huge provisions but it is UK and European banks which have been ordered to cease paying dividends for the time being. In the USA, the large banks are still paying dividends, although Wells Fargo has had to cut its dividend, and no share buybacks are taking place. Banks, especially where there is less regulatory and political interference, can be expected to become more attractive to investors when the world economy improves and the need to make provisions reduces. Insurance companies, also under pressure to omit dividends although not forced to, could also become more attractive again on the yield side. In the UK, for example, Aviva is to resume its dividend, albeit at a lower level. RSA wants to and Legal & General, although with a different profile, resisted pressure not to pay its final dividend this summer and will be paying its interim dividend shortly. If dividend yields appear to be more sustainable and interest rates remain at current levels, one can make a case for a revival in some of these out of favour sectors. Income is so important to many investors that, if the source of the income looks to be more secure, it will attract investment. In terms of companies which have been badly affected by the economic consequences of the pandemic, one has to distinguish between those companies whose businesses will recover in normal economic conditions and those where the outlook has permanently changed for the worse. In the latter category may be companies which will nevertheless survive and be able to benefit from the demise of some of their competitors. In this latter category, the airline industry comes to mind. There have already been a number of failures, and no doubt there will be more, but the airlines which survive will, for example, have more pricing power.

So, as investors look back on the first eight months of this extraordinary year, what might they expect for the rest of this year and beyond? It is reasonable to expect that monetary and fiscal policy will remain supportive, although, later on as we have discussed, hard decisions will have to be made about how to repair countries' finances. All of the big issues that, in normal circumstances, we would be discussing in this review, like the forthcoming US elections and the trade war between the USA and China, assume secondary importance to the path of the pandemic and the economic repercussions arising from it. It is not necessarily going to remain the case because these are two potentially major considerations for markets. At the moment, it is monetary and fiscal policy which overshadows these issues. After such a strong recovery in markets, it is realistic to expect some periods of weakness, but the longer term case for equities outlined here remains intact.

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