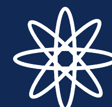

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Investors have enjoyed a successful quarter in both equity and bond markets as investors dwell on positive events, such as the prospect of falling interest rates, rather than the negative ones in the form of geopolitical uncertainty. The dominant US market led the way in international equity markets although, for non US investors, weakness in the US dollar parred gains. Gold continued its strong performance as a store of value in uncertain times.

The tables below detail relevant movements in markets :

International Equities 31.05.24 - 30.08.24

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+6.0	+4.7	+8.1	+6.0
Finland	N/C	-1.2	+2.0	N/C
France	-3.5	-4.7	-1.7	-3.5
Germany	+2.9	+1.7	+5.0	+2.9
Hong Kong	-2.3	-5.1	-2.1	-3.9
Italy	+1.6	+0.4	+3.6	+1.6
Japan	-2.0	+2.4	+5.7	+3.7
Netherlands	-2.4	-3.6	-0.4	-2.4
Spain	+1.2	-0.1	+3.2	+1.2
Switzerland	+3.5	+6.6	+10.0	+7.9
UK	+2.5	+2.5	+5.8	+3.8
USA	+7.6	+4.2	+7.6	+5.5
All World Europe ex UK	+0.5	-0.1	+3.2	+1.2
All World Asia Pacific ex Japan	+4.9	+3.0	+6.4	+4.3
All World Asia Pacific	+2.5	+2.8	+6.1	+4.1
All World Latin America	+6.0	-6.1	-3.1	-5.0
All World All Emerging Markets	+5.9	+2.6	+5.9	+3.9
All World	+5.6	+3.3	+6.7	+4.6

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +3.6%

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

Currency	31.05.24	30.08.24
Sterling	4.32	4.01
US Dollar	4.50	3.90
Yen	1.06	0.88
Germany (Euro)	2.66	2.30

Sterling's performance during the quarter ending 30.08.24 (%)

Currency	Quarter Ending 30.08.24
US Dollar	+3.0
Canadian Dollar	+2.0
Yen	-4.3
Euro	+1.2
Swiss Franc	-3.0
Australian Dollar	+1.3

Other currency movements during the quarter ending 30.08.24 (%)

Currency	Quarter Ending 30.08.24
US Dollar / Canadian Dollar	-1.0
US Dollar / Yen	-7.1
US Dollar / Euro	-1.8
Swiss Franc / Euro	+4.3
Euro / Yen	-5.4

Significant Commodities (US dollar terms) 31.05.24 - 30.08.24 (%)

Currency	Quarter Ending 30.08.24
Oil	-4.6
Gold	+7.2

MARKETS

It has been a solid quarter for international equity and bond markets. Dealing firstly with equities, the FTSE All World returned +5.6% in local currency terms, +3.3% in sterling terms, +6.7% in US dollar terms and +4.6% in euro terms. Looking at local currency returns firstly, the FTSE USA Index led the way with a return of +7.6% followed by the FTSE Australia Index, +6.0%, and the FTSE All World Latin America Index, +6.0%. At the other end of the performance table was the FTSE Japan Index, -2.0%, and the FTSE All World Europe ex UK Index, +0.5%. Looking at sterling adjusted returns, we see a somewhat different picture. The FTSE All World Latin America Index, because of currency weakness returned -6.1% whilst the FTSE Japan Index, because of currency strength, returned +2.0%. The USA again outperformed the FTSE All World Index with a return of +4.2% for the FTSE USA Index as did the FTSE Australia Index which returned +4.7%. It is worth noting the strong sterling adjusted performance of the FTSE Switzerland Index, +6.6% as a result of relative market and currency strength.

There were positive returns in the international bond market. Taking ten year government bonds as a benchmark, the gross redemption yield on the UK gilt fell by 31 basis points to 4.01%, on the US Treasury by 60 basis points to 3.90% on the Japanese Government Bond by 18 basis points to 0.88% and on the German Bund by 36 basis points to 2.30%.

There was a mixed performance in the foreign exchange markets. Against the US dollar sterling rose by 3.0%, against the Canadian dollar by 2.0%, against the Australian dollar by 1.3% and against the euro by 1.2%. On the other hand, sterling fell by 4.3% against the Yen and by 3.0% against the Swiss Franc.

In the commodity markets, oil, as measured by Brent crude, fell by 4.6%, whilst gold continued to attract buyers, rising by 7.2%.

ECONOMICS

Despite all the bad news around, international equity markets continue to hold up to the surprise of many who place weight on the many negative factors around. It does seem that investors are gradually coming to terms with the increasing number of potentially very negative events affecting the world, whether they be political or economic, and realise that to act hastily might be costly in the long term scheme of things. How else to explain the insouciance of investors, after a short term shock, to Covid, the Russian invasion of Ukraine and the Hamas attack on Israel. As this is being written many international equity markets are near their all time peaks seemingly taking the bottle half full approach to events. So far this approach has been broadly correct and consistent with a long term approach to investment. In this respect investors' sanguine attitude is to be welcomed.

In recent reviews, not only have we been discussing, as usual, economic issues but, increasingly, political and regulatory ones as, in our view, the latter two influences should be increasingly important in informing investors' judgements. Dealing with these last two influences on markets we must once again emphasise that we are not giving our opinion on what policies we believe are right or wrong, that is not our job, but we are giving our opinion on how various political decisions, although they will often reflect economic actions, and regulatory ones, may affect investors' strategies because of the ways in which they believe markets will react to them. So we might have our own positive or negative opinion on a particular government or regulatory action but the effect on markets or

individual companies may be the opposite. If we take an unrealistically extreme policy, say where a government removed all tax and duty on alcohol, we might think that this was highly undesirable from a health and social aspect but very good news for investors in companies making alcoholic drinks. Of course, nothing is as extreme as this but it makes the point. So, again, we emphasise that Meridian will not be giving its own views on whether we believe policies are right or wrong but we will indicate how various measures may be perceived by investors and therefore affect securities' prices.

Having said that, we will look at political and regulatory actions and divide them into first and second order effects. First order effects might directly affect markets as a whole or individual sectors and companies in particular. Examples of a first order effect might be a government's decision to raise corporation tax. The consequences are obvious. Earnings per share will be lower than they would otherwise have been and probably dividend levels also. That would be a negative policy change as far as investors were concerned and there is little subjectivity in such a view. An example of a specific action which investors would negatively perceive is an arbitrary windfall tax such as UK oil and gas exploration companies are facing. Such a tax specifically cuts their earnings and it is not too subjective a view to say that investors in companies so affected will consider this as a damaging policy. In a regulatory environment, strict price controls or allowable returns on investment for utilities would be likely considered as negative. One example might be the regulatory environment in which mobile phone companies have operated in some parts of the world.

Second order effects may be more about perceptions rather than specific actions but, in the longer term, can affect how investors perceive a particular country and the opportunities or threats that are seen for investment. Such views can drive investment inflows or outflows and increase or decrease the attractions of a particular country or region. Two examples show what we mean. Firstly, foreigners have been disinvesting from Chinese securities. There may be a number or reasons but obvious ones are political and regulatory unpredictability. Sectors go in and out of political favour and, therefore, regulatory favour, thereby raising uncertainty and causing wide moves in share prices. One thing investors dislike intensely is uncertainty. These influences are partly responsible for the poor performance of Chinese shares. On the pure regulatory front, there are examples nearer to home. Investors and companies involved in the tech sectors in the USA,UK and Europe may well feel that regulators have developed an obsession with the industry, seeking to investigate and punish them on a regular basis. If we take the UK for example, Microsoft Corporation, a big investor in the UK, has expressed its exasperation at the regulator's role and questioned the level of its investment in the UK. For a country which is trying to market its credentials as a centre for high tech excellence, these perceptions are not good and are an example of a second order effect which may cause investors to take a negative view of a country as a place for direct investment or through the stock market.

We have been discussing the effects of regulatory activism for some months now and it has been interesting to note that it has moved up the list of issues which politicians and others are pushing. In particular, the Federal Trade Commission under its activist chair, Lina Khan, has come in for particular criticism from the Republicans. You may say, of course, that they would say that wouldn't they but it is a fact that the FTC has come at Big Tech in a very strong way which has caused concern given that it is such a successful industry for the USA.

Before we move on to the economic outlook, let us just finish on the political and regulatory issues which could influence markets, particularly in this year of around 40 elections. In previous reviews, we have discussed those which have taken place. We concluded that the first one, Taiwan, was probably neutral for the stock market, the reason being that the election of the most hawkish candidate on China, Lai Ching Te, was neutralised by his party not having control of the legislature. The Taiwan/China tension could burst into something more serious at any time, of course, but the result was welcomed by the Taiwan stock market which has performed strongly this year. The South African election was always going to be important given the very poor state of the economy and the urgent need for action to try to rebuild it. Investors thought the result was as good as they could hope

for with the centrist and pro business Democratic Alliance (DA) having a seat in government with six cabinet posts and six others going to non ANC parties. With investors viewing the result as a positive development, the South Africa stock market has performed well. In the biggest election of the year in terms of the number of voters, India, the result was a surprise in that Prime Minister Narendra Modi's Bharatiya Janata Party (BJP), although winning the most seats, failed to win the expected overall majority so has had to go into coalition. Once reason why investors like Narendra Modi is for his pro business orientation so forming part of a coalition will inevitably lead to compromises and a probable slowdown in reform. Investors have not lost their enthusiasm for India with the stock market having performed well this year although for sterling investors currency weakness has pared back the gain. It looks so far as if the perception of India, a second order effect, has not been significantly changed by the unexpected election result. However, the same cannot be said of investors' view of the Mexican election results where Claudia Sheinbaum, a protégé of her predecessor Amlo, won a landslide Presidential and legislative majority. The results were badly received by investors with the currency being very weak and magnifying the effect of a weak stock market in local currency terms. A decision to make judges elected by popular vote, which has just been passed, is one of many issues unsettling foreign investors. Here, first and second order effects come into play. The first order effects relate to the economy. Amlo, despite his hostility to the private sector, until the last year followed a conservative fiscal policy but, in the run up to the elections, allowed the budget deficit to rise to around 5% of GDP. The direct effect of this is to weaken the currency which will affect individuals, companies and investors as confidence is lost in the Mexican economy. The second order effect is that foreign investors, seeing another perceived radical and anti business President and legislature, will not regard Mexico as a stable country in which to invest. Mexico is one of the best examples of the link between politics and markets and the reaction of investors has so far been unequivocal.

Nearer home, the unexpected calling of French legislative elections by President Macron following the strong showing for the National Rally (RN) in the elections for the European Parliament has caused a huge amount of uncertainty. The President's gamble of calling elections to try to normalise the position in domestic legislative elections which carry much greater weight and importance than European elections failed spectacularly and, although the RN fell back in the second round, the extreme left gained much more influence with the left coalition, which was hastily brought together, gaining the most seats but not a majority. This has led to a serious position in France. It has a large budget deficit around 5.5% of GDP which has attracted the attention of the European Commission and yet there is complete stalemate in the legislature. We can say that there are first and second order effects here and the relative weakness of the French stock market this year is no coincidence. It is down to politics and it is difficult to see how the quite serious economic problems of France can be tackled.

And, of course, more recently there has been the UK's General Election. When a new government comes into power, one which has been out of office since 2010, there is bound to be a lot of interest in terms of policies which are significantly different from those of the outgoing government. It is very early days and October's budget, which the government has warned will be very painful, will tell investors more but there are a small number of indications of where investors may be heading. One first order effect is on the oil and gas industry where the new Chancellor has stiffened the windfall tax imposed by the previous government, thus directly affecting certain companies adversely. But investors in the industry specifically and the UK generally may well feel that they cannot trust the UK's tax regime to be stable and not selectively punitive. The treatment of the offshore energy industry can be seen by some investors as a reason to avoid the UK with both the previous government and this one being complicit. Furthermore the decision by the UK government not to challenge judicial reviews against the development of the Rosebank and Jackdaw offshore oil and gas fields will be seen as an indirect attempt to close down the offshore oil and gas industry. A second order effect may be seen in the stiffening of the non domiciled rules for certain people in the UK. Some will see the previous and current governments' tightening of the rules as populism triumphing over rational economic decision making and therefore a reason to take a more sceptical view about

investing in the UK. Investors might read two other second order events as negative for the UK. One of the government's first actions was to approve above inflation pay awards to groups in the public sector. We emphasise again that we are not giving a view as to whether this is right or wrong but it is not controversial to say that these awards set a marker and may have implications for the general level of inflation and therefore the interest rates which the Bank of England will set. If interest rates have to be kept higher than previously expected because inflation is proving sticky, investors would be likely to take that negatively. As we have said before perceptions of a country are important. It is standard procedure for new governments to paint a bad picture of the legacy which they have inherited in order to provide cover for what they may want to do on the policy front. However, investors may feel that the new government has taken this to an altogether different level in painting a very gloomy picture of the UK's economic position. Foreign investors will take note and it is damaging for the UK insofar as it could deter inward investment. One may say that this is what politicians do but there can be a cost, in this case a deterrent to some foreign investment in the UK. As The Times pointed out in an editorial on 28th August, countries like France and Germany are in a much worse state than the UK and all is not bad in the UK. As The Times says, the latest figures suggest that the UK is growing faster than any other G7 country except the USA. A CEO would not paint his or her company in such a gloomy light because it would damage this business. A prime minister is in no different a position as regards the UK. On the other hand, what might seem a trivial example but which is actually important, on a positive note, is the government's approval of an increase in the annual passenger cap from 6.5 million to 9 million at London City Airport. The reason it might be viewed as a positive second order effect is that some will see it as an example of the UK being open for business at a time when airport expansion plans in some countries are being opposed.

But, of course, the most significant elections are yet to come, namely those for the Presidency and Congress in the USA in November. The Sunday Times' US writer, Irwin Stelzer, headed his article on 25th August, "Kamala Harris and Donald Trump deserve an F in exams". So, that doesn't sound very promising for the US stock market, yet here it is at around all time highs so there is a disconnect somewhere. Of course, Presidents have to get their plans past Congress which is why we place a lot of attention on what might happen in the races for the Senate and House of Representatives. Kamala Harris has said that she wants to try to do what President Biden couldn't do, namely raise taxes with the corporate tax rate to go from 21% to 28%, obviously not good for earnings per share and dividends. She would quadruple the current 1% tax on share buybacks to 4%, something that would be damaging for the stock market. There would be other measures which would negatively impact investors. She has also attacked companies in certain sectors for what she calls "price gouging". If she plans some sort of price control mechanism, investors would undoubtedly regard that as a highly negative signal. Donald Trump wants to put a 10% tax on imports and higher levels on Chinese imports. What would that do? It would raise inflation, keep interest rates high and push the US dollar higher, most probably, something that Donald Trump would not like given his attack on some countries for currency manipulation. Of course, there is a lot more to their policies (which may change) but these give some idea of why Irwin Stelzer awards them "F" for economics. This is all still to come but some of the political issues we have discussed give an idea of why politics (although inevitably bound up with economics) can be so important for investors' decision making. So, the US elections will be an important market event one way or another.

Nevertheless, notwithstanding the political background in various countries including those we have specifically mentioned so far in this review, international stock markets remain near peak levels as measured by the world indices. As well as rising corporate earnings in many countries, expectations of interest rate easing by central banks have increased and there have been reductions in interest rates in countries including the UK, Switzerland, Canada and in the eurozone. In the opposite direction has been Japan. Interest rates will largely be guided by whether the relevant central bank feels that inflation is moving sustainably in the right direction. Having been caught out in 2021 when central banks underestimated the inflation threat, they do not want to caught out again. With central banks' target inflation rates being around 2%, there is still some way to go and the "last mile" as it is called, the difference between current inflation rates and central bank interest rates, being particularly hard

to achieve. In the USA, inflation is currently 2.9%, in the UK 2.2% and in the eurozone, 2.6%. It seems almost a done deal that the US Federal Reserve will cut its interest rate at its next meeting, especially as there is some evidence that the US economy is weakening. The imminence of the US elections is not likely to deter the Federal Reserve from cutting interest rates.

Bond yields have fallen significantly over the last three months on the better inflation outlook but the reason we remain cautious about the international bond markets is the poor state of governments' finances throughout the world and the resulting large borrowing requirements which necessitate very significant bond issuance. If we take the USA, the Economist Intelligence Unit's estimate for 2024 is a budget balance of -6.8% of GDP and the Congressional Budget Office sees years of this level of borrowing. One has to feel that there will be some sort of reckoning in the US Government bond market in the face of this magnitude of deficits. That will surely come through the interest rate at which buyers are willing to bid for stock. There are some very large budget deficits in the euro area which has caused the European Commission to launch excessive deficit procedures against France for one. We touched upon this earlier when discussing politics and the political instability in France. With a budget deficit expected to be around 5.5% of GDP this year and outstanding public debt at over 100% of GDP and little prospect of a stable coalition government and therefore almost certain policy drift, the French bond market could be facing a very difficult challenge. In relative terms, taking ten year government bonds as a benchmark, France has to pay more than a 70 basis point premium over Germany. It has to pay a 13 basis point premium over Portugal for its ten year bonds. France is in a very difficult position since there is no parliamentary majority for the sort of action which needs to be taken to address the excessive budget deficit which is required by the EC to move towards 3% of GDP. Italy, too, has an issue. It is even more indebted than France and its budget deficit as a percentage of GDP is likely to be almost as large as that of France. Italy has to pay a premium at present of about 137 basis points over Germany on its ten year bonds and this remains a pressure point within the eurozone. Because France and Italy are in a currency union, problems in any of the major eurozone countries can easily spread to the currency bloc as a whole. With bond yields as they are in most countries and the supply situation caused by the continuing needs to fund very large deficits, it is easy to see pressure on yields resuming. Furthermore with the main central banks engaging in quantitative tightening as they sell securities back to the private sector or do not reinvest maturing bonds the effect is magnified. So whilst bond investors may be taking comfort from the improving inflation prospects, we do not think that the enormous borrowing requirements of many governments can be ignored because, at some stage, investors are going to want to be paid more to lend to them. Also, the possibility of a problem in the eurozone, for example, could pose a systemic risk to the eurozone bond market in general.

So far this year international equities have performed well and one of the reasons will have been the prospect of interest rates being reduced in the face of the better inflation outlook. However, the equity markets also performed much better than expected when interest rates were rising so the recent rise is from a higher basis than might have been expected. A lot of this can be due to the outsize movements of some of the big tech companies caught up in the AI excitement. Fundamentally, equities can draw some comfort from the prospect of modest world economic growth, the IMF puts it at 3.2% this year and 3.3% next year. These are just about satisfactory levels but they are enabling corporate profits to be increasing in many countries and, with them, dividends as they probably have fewer headwinds than bonds. Equity investors have to be wary that the rise of populism and associated anti-business feeling can translate into anti-business and anti-investor measures. The cost of living crisis has put big companies in the politicians' and regulators' cross hairs. Politicians and regulators have, seemingly, become more hostile, particularly to the big tech sectors. And, of course, the world is a very unpredictable place now so markets could be upended by one or more geopolitical events. As indicated in the early part of this review, we need to watch the politics very closely as many politicians are on businesses' back. Nevertheless, we continue to have equities as our preferred asset class with wide geographical exposure to reduce country specific risk. We must expect periods of weakness in the long term upward path of equities and watch the actions of politicians and regulators closely.

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