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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

The fourth quarter has ended on a satisfactory note for international equity investors with positive returns in most developed as opposed to emerging markets. Fixed interest securities, as measured by ten year government bonds, showed little change. In the currency markets, sterling was generally stronger. Gold was slightly stronger, whilst the oil price stabilised, at least temporarily.

The tables below detail relevant movements in markets :

International Equities 30.09.21 - 31.12.21

| Total Return Performances (%) | | | | |
|---------------------------------|----------------|-------|-------|-------|
| Country | Local Currency | £ | US\$ | € |
| Australia | +1.9 | +2.1 | +2.5 | +4.5 |
| Finland | +5.5 | +3.0 | +3.5 | +5.5 |
| France | +9.0 | +6.5 | +6.9 | +9.0 |
| Germany | +2.6 | +0.2 | +0.6 | +2.6 |
| Hong Kong, China | -3.5 | -4.1 | -3.7 | -1.8 |
| Italy | +7.6 | +5.1 | +5.6 | +7.6 |
| Japan | -1.4 | -4.9 | -4.5 | -2.6 |
| Netherlands | +5.2 | +2.7 | +3.2 | +5.2 |
| Spain | +0.9 | -1.4 | -1.0 | +0.9 |
| Switzerland | +10.2 | +12.3 | +12.8 | +14.9 |
| UK | +4.7 | +4.7 | +5.1 | +7.1 |
| USA | +10.1 | +9.6 | +10.1 | +12.2 |
| All World Europe ex UK | +6.5 | -0.7 | +5.2 | +7.2 |
| All World Asia Pacific ex Japan | -0.4 | -2.2 | -0.3 | +1.6 |
| All World Asia Pacific | -0.8 | -0.3 | -1.7 | +0.1 |
| All World Latin America | -1.6 | -3.8 | -3.3 | -1.5 |
| All World All Emerging Markets | -0.5 | -1.4 | -1.0 | +0.9 |
| All World | +7.0 | +6.2 | +6.6 | +8.7 |

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +2.4%

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

| Currency | 30.09.21 | 31.12.21 |
|----------------|----------|----------|
| Sterling | 1.02 | 0.96 |
| US Dollar | 1.49 | 1.51 |
| Yen | 0.07 | 0.06 |
| Germany (Euro) | -0.20 | -0.19 |

Sterling's performance during the quarter ending 31.12.21 (%)

| Currency | Quarter Ending 31.12.21 |
|-------------------|-------------------------|
| US Dollar | +0.4 |
| Canadian Dollar | +0.1 |
| Yen | +3.7 |
| Euro | +2.2 |
| Swiss Franc | -1.7 |
| Australian Dollar | -0.2 |

Other currency movements during the quarter ending 31.12.21 (%)

| Currency | Quarter Ending 31.12.21 |
|-----------------------------|-------------------------|
| US Dollar / Canadian Dollar | -0.3 |
| US Dollar / Yen | +3.2 |
| US Dollar / Euro | +1.6 |
| Swiss Franc / Euro | +4.2 |
| Euro / Yen | +1.6 |

Significant Commodities (US dollar terms) 30.09.21 - 31.12.21 (%)

| Currency | Quarter Ending 31.12.21 |
|----------|-------------------------|
| Oil | -1.3 |
| Gold | +5.3 |

PERFORMANCE DURING 2021

International Equities 31.12.20 - 31.12.21

| Total Return Performances (%) | | | | |
|---------------------------------|----------------|-------|-------|-------|
| Country | Local Currency | £ | US\$ | € |
| Australia | +16.9 | +11.2 | +10.1 | +18.5 |
| Finland | +25.4 | +17.6 | +16.6 | +25.4 |
| France | +29.1 | +21.1 | +20.0 | +29.1 |
| Germany | +13.8 | +6.7 | +5.7 | +13.8 |
| Hong Kong, China | -3.6 | -3.3 | -4.1 | +3.1 |
| Italy | +24.8 | +17.1 | +16.0 | +24.8 |
| Japan | +13.2 | +2.5 | +1.5 | +9.2 |
| Netherlands | +38.5 | +29.9 | +28.7 | +38.5 |
| Spain | +10.4 | +3.6 | +2.7 | +10.4 |
| Switzerland | +24.4 | +21.8 | +20.7 | +29.9 |
| UK | +18.4 | +18.4 | +17.3 | +26.2 |
| USA | +26.8 | +28.0 | +26.8 | +36.5 |
| All World Europe ex UK | +24.5 | +17.6 | +16.6 | +25.4 |
| All World Asia Pacific ex Japan | +1.6 | -0.1 | -1.0 | +6.5 |
| All World Asia Pacific | +5.4 | +0.8 | -0.1 | +7.5 |
| All World Latin America | -2.1 | -7.7 | -8.6 | -1.6 |
| All World All Emerging Markets | +1.8 | +1.0 | +0.1 | +7.7 |
| All World | +21.4 | +20.0 | +18.9 | +27.9 |

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -5.2%

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

| Currency | 31.12.20 | 31.12.21 |
|----------------|----------|----------|
| Sterling | 0.19 | 0.96 |
| US Dollar | 0.91 | 1.51 |
| Yen | 0.01 | 0.06 |
| Germany (Euro) | -0.58 | -0.19 |

Sterling's performance during the year ending 31.12.21 (%)

| Currency | Year Ending 31.12.21 |
|-------------------|----------------------|
| US Dollar | -1.1 |
| Canadian Dollar | -1.7 |
| Yen | +10.3 |
| Euro | +6.3 |
| Swiss Franc | +2.0 |
| Australian Dollar | +4.8 |

Other currency movements during the year ending 31.12.21 (%)

| Currency | Year Ending 31.12.21 |
|-----------------------------|----------------------|
| US Dollar / Canadian Dollar | -0.6 |
| US Dollar / Yen | +11.5 |
| US Dollar / Euro | +7.3 |
| Swiss Franc / Euro | +4.3 |
| Euro / Yen | +3.9 |

Significant Commodities (US dollar terms) 31.12.20 - 31.12.21 (%)

| Currency | Year Ending 31.12.21 |
|----------|----------------------|
| Oil | +50.4 |
| Gold | -3.1 |

MARKETS

International equities ended the year on a firm note with a positive final quarter. In local currency terms, the FTSE All World Index showed a total return of +7.0%, in sterling terms, +6.2%, in US dollar terms, +6.6% and, in euro terms, +8.7%. Looking at local currency returns first, the USA and Switzerland had stand out quarters. The FTSE USA Index returned +10.1% and the FTSE Switzerland Index +10.2%. The FTSE All World Europe ex UK Index was only slightly below average with a return of +6.5%. The FTSE UK Index, whilst performing well in absolute terms, was below average with a return of +4.7%. Elsewhere, the FTSE Australia Index, whilst showing a positive return, was well below average at +1.9%. There were negative performances from the FTSE Japan Index, -1.4%, and from the FTSE All World Asia Pacific Index, -0.8%, the FTSE All World Asia Pacific ex Japan Index, -0.4%, the FTSE All World All Emerging Markets Index, -0.5%, and from the FTSE All World Latin America Index, -1.6%. When looked at in sterling adjusted terms, there was not an enormous difference. The FTSE Australia Index return increased slightly to +2.1% and the FTSE Switzerland Index more notably to +12.3%. On the negative side, the return on the FTSE Japan Index became weaker at -4.9% and on the FTSE All World Europe ex UK Index at a still good +4.7%. The returns on the emerging markets regions also became more negative in sterling terms.

In the fixed interest market, as measured by ten year government benchmark bonds, there was little change. The gross redemption yield on the UK bond fell by 6 basis points to 0.96% and on the Japanese Government Bond by 1 basis point to 0.06%. On the German Bund, the gross redemption yield rose by 1 basis point to -0.19%. On the US Treasury bond, it rose by 2 basis points to 1.51%. So, overall, there was not much movement.

In the foreign exchange market, the Yen and euro weakened. Against them, sterling rose by 3.7% and 2.2% respectively. Sterling also rose against the US dollar by 0.4% and against the Canadian dollar by 0.1%. On the other hand, it fell against a strong Swiss Franc by 1.7% and against the Australian dollar by 0.2%.

In the commodity markets, oil, as measured by Brent crude, fell by 1.3%, whilst gold rose by 5.3%.

If we now turn to looking at the calendar year returns, equities showed a healthy but patchy performance. In local currency terms, the FTSE All World Index returned +21.4%, in sterling terms, +20.0%, in US dollar terms, +18.9% and, in euro terms, +27.9%. Looking at the returns as a whole, the relative weakness shown in Q4's performance from emerging markets was symptomatic of the calendar year's performance. Looking at local currency returns first, the FTSE USA Index is the stand out performer, with a return of +26.8%. The FTSE All World Europe ex UK Index also showed an above average performance with a return of +24.5%. The return on the FTSE UK Index at 18.4% was excellent in absolute terms but continued its record of relative underperformance. The FTSE Japan Index, +13.2%, and the FTSE Australia Index, +16.9%, also underperformed. But, whilst developed markets showed an exceptionally good performance in 2022, this was not the case for Latin America, Asia Pacific ex Japan and Emerging Markets, where the returns were respectively -2.1%, +1.6% and +1.8%. Sterling adjusted returns showed some notable differences resulting from currency movements. This was reflected on the positive side in the FTSE USA Index, which returned an astonishing +28.0% but, elsewhere, the movements were mainly the other way. Most notably, this was the case in Japan, where the sterling adjusted return was barely positive at +2.5%. The return on the FTSE All World Europe ex UK Index, at +17.6%, fell below that of the FTSE UK Index, +18.4%, when adjusted for currency movements. Elsewhere, the return on the FTSE Australia Index fell back to +11.2%. Currency weakness against sterling also impacted on the FTSE All World Asia Pacific ex Japan Index where the return became slightly negative at -0.1%, and even more so on the FTSE All World Latin America Index which returned -7.7%.

As expected, bonds significantly underperformed equities in 2021. Taking the ten year government bond yields as a benchmark, the gross redemption yield on the UK gilt rose by 77 basis points to 0.96%, on the US Treasury bond by 60 basis points to 1.51%, on the Japanese Government Bond by 5 basis points to 0.06% and on the German Bund by 39 basis points to a still negative -0.19%. On the foreign exchange markets, sterling had a mixed performance. Against the Canadian dollar, it fell by 1.7% and against the US dollar by 1.1%. On the other hand, it rose by 10.3% against a very weak Yen, by 6.3% against a similarly weak euro, by 4.8% against the Australian dollar and by 2.0% against the Swiss Franc.

In the commodity markets, oil recovered strongly on the back of a resurgence in demand and supply limitations, but gold had a poor year, given all the uncertainties around, and it fell by 3.1%.

ECONOMICS

In these end of year reviews, we often look back twelve months to see whether our thoughts about the coming year were right or wrong or, more likely, a bit of both, and to see if the reasons for our views articulated at that time stood up over the course of the following year. The end of 2020 was not, of course, a normal time so crystal ball gazing was more than usually difficult.

Stating the obvious at that time, namely the difficulty of calling out the course of the pandemic, we did, however, draw attention to the lack of any attraction in the fixed interest market and the fairly certain underpinning of interest rates by central banks which we thought would support equities, even if they were, historically, overvalued. We also emphasised the importance of geographical diversification and investing in high quality companies. We said that long term investors should maintain their current positions, namely wide geographical exposure to high quality equities. So how did these thoughts turn out?

The call on the fixed interest market was generally right. If we consider the UK market, it was a disappointing year for investors in conventional bonds, with returns being generally negative, and that was the case elsewhere. Index linked bonds provided modest positive returns as inflationary expectations rose. However, they were nowhere near the level of returns shown by equities. The call on central banks continuing to underpin interest rates was not a difficult one and it was correct to think that this easy monetary policy would continue to support equities. It was certainly right to emphasise the importance of geographical diversification. Most, but not all, equity markets performed well in 2021 but the USA, by far the largest market, was outstanding and significant exposure to this market has helped to lift portfolio performances in 2021. The UK market has performed well, but not as well as the US one, showing, once again, for sterling based investors, the danger of home bias. We thought that quarterly fluctuations in valuation levels were inevitable but, in the event, apart from a standstill third quarter, the market movements of equities were mostly upwards, so we were a little cautious here. Overall, returns in the international equity markets were higher than we expected, but the broad thrust of our arguments turned out to be correct.

The strength of international equity markets in 2021 should not breed any complacency. We remain in uncharted territory. One of the most surprising features of 2021 was the reluctance of central banks to recognise that inflation was becoming a problem. The message for much of the year was that the rise in inflation was transitory, even as inflation rates started to exceed target levels by a wide margin. Whilst one must accept that central bankers truly believed this was the case, many commentators were increasingly incredulous about their forecasts and we recognised this view in previous monthly

economic commentaries. Whilst judgements taken with the benefit of hindsight rightly annoy many people, in this case, all one's instincts pointed to inflation becoming more entrenched than central bankers were prepared to admit. The central bankers' view relied upon the issue being one of pandemic induced supply problems which caused shortages which, in turn, pushed up prices but that, once normality returned to the supply chain, prices would fall back. Whilst one could accept that this viewpoint could be supported, most of the evidence pointed the other way. Many employers found it difficult to find staff to replace those who had disappeared from the system and terms like the "Great Resignation" became commonplace. Pay was raised to try to attract new recruits and many governments raised minimum wage rates. Once these types of cost increases become embedded in the system, they are difficult to reverse. One of the big drivers of inflation has been energy prices and, for various reasons, they are likely to remain a problem. As we ended the year, there was a noticeable change in the tone of central bank pronouncements and much more acceptance that there is a problem, so that we can reasonably assume that we will not be seeing inflation described as "transitory" nearly as much or possibly not at all.

There are always issues to concern investors and, as we enter 2022, the (hopefully) shorter term one is Covid-19 and, beyond that, the interaction of interest rates and inflation. Not far behind, are geopolitical concerns about the possible actions of Russia and China. As this review is starting to be written, right at the end of 2021, day to day movements of the stock markets are being influenced by the latest news on the Omicron variant, on the negative side by the extent to which it is spreading and, on the positive side, that it does not appear as dangerous as existing variants and that existing vaccines seem quite effective when they are used as booster doses. These variables can, of course, change for the better or worse and markets will be very sensitive to news either way, so that day to day movements may become more uncertain than ever.

If we accept that markets are in the short term hands of the Omicron variant, and any others which may follow, we can attempt to tackle the issue which above target inflation and negative real interest rates pose for investors against a background of an almost certain tightening of monetary policy by central banks around the world. The latest consumer price indices for various countries at the time of writing (post quarter end) are :

| | | 10 year Government Bond Yields (at time of writing) | Policy Rate |
|----------|------|--|------------------------|
| USA | 6.8% | 1.76% | 0.25% |
| UK | 4.6% | 1.18% | 0.25% |
| Eurozone | 5.0% | | 0.00% |
| France | 2.8% | 0.28% | 0.00% |
| Germany | 5.3% | -0.05% | 0.00% |
| Italy | 3.9% | 1.31% | 0.00% |

The level of negative real interest rates is staggering and would have astonished many economists in the past, let alone the present. It is hard to believe that any central banker would willingly allow this situation to occur and the strong conclusion must be that inflation has got away from them and that they are behind the curve. Of course, there are extenuating circumstances, namely the pandemic and its economic consequences. Trying to balance the competing threats of out of control inflation and economic stagnation or recession is not easy and a great deal of sympathy must be directed towards the policy setting committees. Nevertheless, it is hard not to feel that central banks have been working quite closely with the various countries' or regions' finance ministries and that they have, in effect, been financing the massive fiscal packages which have been put in place to prevent economic collapse as a result of the effect which Covid-19 has had on different countries' finances. Central banks should be independent of government to maintain the credibility of monetary policy.

At this stage, it is worth reminding ourselves why negative real interest rates have been considered dangerous. The inflationary potential is obvious. If an individual or company can borrow at a negative interest rate, then the desire to take on extra borrowing and spend or invest the money threatens to overheat an economy as supply cannot keep up with demand, thereby pushing prices higher. As well as day to day goods, the demand for assets like property creates the potential for a bubble in this market, with a potential danger for individuals and banks if the bubble bursts. Coming one stage further, it raises risk levels as it fuels demands for assets like cryptocurrencies which have no backing. The table above shows how dire the position of savers, who might previously have expected to earn a return on their bank deposits or fixed interest securities, has become. Not only are they not obtaining a return on their money, but they are seeing its purchasing value go down in front of their eyes. In their search for a replacement of the interest they would previously have earned, the temptation to buy risky assets is heightened and investment decision making is distorted.

At some stage, the pressure on central banks to react to inflation levels well above what they were expecting will become intense and, if they are behind the curve in raising interest rates, they may well have to raise interest rates to a much higher, or at a faster rate, level than they would have done in a normal cycle and bring economies to a resounding halt.

With monetary policy as extreme as it is in terms of ultra low or negative interest rates and quantitative easing (QE) continuing to be undertaken, price signalling has disappeared and this is a highly undesirable situation. Price signalling is very important in economics and there are many malign effects when it is suppressed, as it is at the moment. This applies to the stock market as well as the economy. In terms of the economy, risks become mispriced and a good example of this is the eurozone where the downside risks of a single currency will become apparent sooner or later. Because of interest rate suppression, caused by the ECB's actions, there is no real pricing of risk. So, highly indebted countries like Greece and Spain can borrow for ten years, at the time of writing, at current rates of 1.53% and 0.65% respectively. The best quality credit, Germany, can borrow at -0.05%. Germany is an AAA credit, Greece a BB credit and Italy a BBB+ credit. The yield differentials do not reflect the differences in the credit qualities as implied by the ratings. Investors have been happy to buy the more lowly rated sovereign bonds on the basis that the ECB has been buying them in the secondary market and they are also happy to accept negative real yields. If investors think the ECB will support the eurozone bond market indefinitely, that can explain why they would be prepared to accept the credit risk. Unless investors have to buy bonds, and many institutions do, the only reason for buying them on negative real yields would be that they think inflation is going to collapse or because they think all other assets are so unattractive that they would lose less in bonds. Now, it is true that the ECB appears to be the central bank most reluctant to start tightening monetary policy, but even it must recognise that it will need to tighten policy in the light of inflationary pressures. The problem here is the "one size fits all" policy of a monetary union. Governments and companies which are heavily indebted, have been able to service debts when interest rates are so low. The problem will come when debt servicing costs rise with the resultant negative effect on countries' budgets. This is a risk which is nowhere near properly priced at present. Of course, it is possible that the ECB bond buying will continue indefinitely, in effect monetising debt. That will be inflationary, leaving investors facing an indefinite period of negative real yields and probable currency weakness, which cannot be a desirable investment outcome, even if they do not face defaults. Realistically, the ECB will take tightening action at some stage, so investors will face interest rate and credit risks. In countries like the USA and UK which have their own central banks, unlike members of the eurozone, sovereign defaults should not happen, but the inflationary dangers and, therefore, the dangers of negative real yields, will be ever present.

Admittedly, central banks had little alternative to turning on the money taps when the pandemic crisis erupted early in 2020 but, now that the world economy is recovering, notwithstanding a, hopefully, temporary slowdown caused by the Omicron variant, they have to start to reverse the monetary policy's crisis measures. If price signalling had been allowed to work, leaving aside, for the moment, the circumstances which caused monetary policy to take the course which it has, we would see much higher nominal interest rates, almost certainly positive real yields, an economy where demand and supply were much more in balance and lower inflation than we see at present. The threat of higher interest rates and its effect on debt servicing costs would normally cause governments to address budgetary and therefore creditworthiness issues. If markets were concerned about a country's finances, market signalling would be reflected in interest rate and currency levels. If inflation were a concern, price signalling would also be reflected in interest rate and exchange rate levels. The danger which the absence of price signalling could cause in present circumstances is that the normal constraints could disappear and that inflation and creditworthiness of some countries could lead to an economic crisis.

In the same way that the absence of price signalling can give a false indicator of the creditworthiness of some countries, so it is in the corporate sector. The popularity of lowly rated corporate bonds as a way of obtaining a higher yield carries its own risks. The suppression of yields by central banks as a result of their bond buying programme has meant that investors have not always been adequately recompensed for the risks which they are taking. A negative side effect of weak companies being able to stay afloat is that, whilst they may not be able to repay their borrowings, they can service their debts and that reduces the market opportunities for healthy companies which have better growth prospects, thereby having a negative effect on an economy's potential growth rate.

We have touched upon the distortions caused to the financial markets by very loose monetary policy and, at least in the short term, the monetary transfers from savers to borrowers. With interest rates so low, even after the recent small 0.15% increase in the UK, bank deposits and similar offer deeply negative real interest rates, as do good quality government and fixed interest securities. There are problems here. The immediate one is that these assets provide an inadequate income return for savers. Traditionally, bonds and cash have been thought of as assets which will limit portfolio volatility because they are stable assets. But there is a big danger here. Even if the quality of the bonds is good and, therefore, holding little danger of default, an upward movement in interest rates will cause the capital value of the bonds to fall, perhaps by quite a long way, depending on the bonds' maturity date and the extent of the rise in yield. They could prove to be highly volatile. It is important that investment thinking keeps up with the danger that rising interest rates pose for bonds. They can no longer be considered a safe low volatility asset in a world where the trend of interest rates is likely to be upwards.

So, where to go if cash and fixed interest securities cannot provide the income that savers require? The danger of the present situation is that savers feel that they have to put money into more risky assets in order to achieve the return they desire. In a world where money supply has been growing quickly as a result of monetary policy, it is not surprising that asset prices have been rising. Grossly oversimplifying, more money chasing a finite amount of assets will push up the price of those assets. The risks are obvious when one considers what type of asset may have been bought. Cryptocurrencies spring immediately to mind as an asset at the risky end of the spectrum. It is true that the price has risen sharply but it is also very volatile and one has to ask what is supporting it. It is highly speculative and is one of the manifestations of the fall out from very low interest rates. Regulators, central bankers and politicians all fear the fall out for individuals and the financial system (not now but sometime in the future) from a bursting of the cryptocurrency bubble. On a smaller scale, but serious for some savers, is the proliferation of "too good to be true" offers by some firms. These would typically be in assets offering a return way above what can reasonably be expected. The money pages of national newspapers regularly carry stories of investors who have fallen for assets offering very high interest rates only to

find that they cannot recover all, or even any, of their money. That individuals have fallen for these scams is a function of the current distorted financial scene. Then there is property. For individuals wanting to buy a house simply to live in, ultra cheap money chasing a limited amount of property has pushed up house prices to scarcely affordable multiples of income. But it also encouraged investment into the “buy to let” market as a way for investors to earn a return not available on cash or fixed interest securities. However, certainly in the UK, that avenue is becoming less attractive for investors as the government has moved to make the market less attractive. Gold, a traditional diversification, has had an unexciting year, so it appears not to have attracted interest in the way that cryptocurrencies have, although gold has a use. The property market, not here talking about the “buy to let” market, has seen its various segments produce different performances. The best sector has been the industrial property market with warehouses being in demand as on line shopping has increased during the pandemic over and above the trend for it to increase anyway. But commercial and retail have been difficult for obvious reasons associated with the pandemic. This leaves shares, and the performance of equity markets in 2021 indicates that there has been investor interest, perhaps not from investors who would usually favour the market. Whilst this is not true of the largest equity market, the USA, any longer, most other equity markets offer higher yields than their own bond markets. For example, the dividend yield on the FTSE 100 Index is currently (post quarter end) about 3.8%, whilst the ten year government bond yields 1.19%. For Germany, the relevant figures are 2.1% and -0.04%, for France 2.1% and 0.33% and for Switzerland 2.5% and -0.01%. In Japan, the figures are 1.68% and 0.14%. In the USA, however, the dividend yield on the S & P 500 is 1.29% and on the ten year government bond 1.76%. Nevertheless, with dividend growth expected, plus share buybacks, the difference does not look significant.

For those, who looked for “riskier” assets than cash or fixed interest securities in 2021, shares proved to be a successful alternative given the positive level of real returns which many achieved. Undoubtedly, very loose monetary policy has helped to push share prices higher. That has been one of the reasons why we have indicated for a long time in our reviews that shares are our favoured asset class. Even those who have been sceptical about the value of holding shares as an alternative to the so called stabilising influence of cash and bonds in a balanced portfolio would, perhaps, admit that there is at least an argument for holding shares or raising the weighting in a balanced portfolio.

Before we come back to look at the outlook for 2022, we should touch upon two other uncertainties for investors which certainly fit into the risk category and these are the geopolitical risks surrounding Russia and China. Investors cannot base their policy on the possibility of Russia invading Ukraine or China seeking to seize Taiwan. There are always possible problems to be concerned about but one cannot run a long term portfolio on the basis that the worst is going to happen, resulting in either selling securities or holding excessive cash levels. If Russia invades Ukraine or China invades Taiwan there is bound to be a market reaction. Obviously, investors will watch events closely and, if either or both of these scenarios occur, markets will react badly, at least in the short term. But, as we see the situation now, markets are not taking these possibilities into account.

Absent these geopolitical issues and a worsening of the pandemic, we think that the main issue for markets will be the interaction of monetary policy with the inflation background. On the basis that central banks will come round to the thinking that their earlier views about inflation being transitory have not proved to be correct, we expect the emerging trend of reining back on QE and raising interest rates will gather momentum in the face of the inflation threat. Whilst this will be bad news for fixed interest markets, where we retain our bearish stance, the key question is about how equity markets will react. In previous reviews, we have emphasised how important central banks’ signalling to markets is. Investors do not like unwelcome surprises, as we saw in the “taper tantrum” in 2013. If investors have time to assimilate changes in monetary policy, the reaction is likely to be less severe than if they are caught unawares.

We can show a simple example of how rising interest rates can affect the attraction of equities. If we take the S & P 500 index in the USA, the forward looking price/earnings ratio for the next twelve months is somewhere around 22, which equates to an earnings yield of around 4.5%, compared with the risk free rate of around 1.76% if one were to take the ten year US Treasury bond and almost nothing if one took the risk free rate as a short term US Treasury bill. So, although the forward price/earnings ratio on the S & P 500 is above its historical average, the low level of interest rates can justify this. But, as investors want a premium for the risk of investing in equities compared with safe assets, rising interest rates pose a threat to equities. They also reduce the net present value of future earnings which are discounted at a higher rate, which is why, at least in the early stages of interest rate rises, value stocks, which have the almost certainty of a steady stream of profits, are favoured against growth stocks whose earnings may well be in the future, if they are, say, in the technology sector. So, it is easy to see why rising interest rates may be seen as a threat to equities, although perhaps less so if they have good visibility on the outlook because of careful central bank signalling. But we must also consider that we are in the unusual situation of very high negative real interest rates. In purely investment terms, the ten year US Treasury bond, if held to maturity, is going to be a very poor investment, almost certainly leading to a large loss in inflation adjusted terms. That being the case, might shares offer the possibility of an acceptable real return? They have certainly done that in 2021 and in recent years. The answer partly depends on macroeconomic conditions, obviously, but also in terms of a company's pricing power which, if strong, can reflect the effects of inflation and that will be a function of their industry position, technological leadership and inflation linked prices, to name but three factors. Cost control would also be vital, with the ability to raise profit margins. With tight and more expensive labour in many industries, one can be sure that companies will be looking to technology to automate as many processes as possible. Again, there may be other industries, like mining, where it is difficult to raise capacity quickly for various reasons but where demand is likely to be strong in the future, with just one example being copper. There will be many more examples but, in the foreseeable future, with inflation likely to be a problem, pricing power will give certain equities the edge.

With share ratings high for the reasons given, it is still important that the world economy grows and, with it, profits and dividends. After the pandemic induced recession of 2020, there has been a sharp bounce back in 2021 and corporate profits have recovered sharply. In its latest Economic Outlook, the OECD forecasts economic growth of 5.6% in 2021 following a decline of 3.4% in 2020, so that World GDP now exceeds pre-pandemic levels. For 2022, it now expects growth to be 4.5%. In the current environment, forecasts have to subject to more than usual caveats, but the OECD's forecasts point to a good recovery, with the 2023 figure being 3.2%. Looking at individual forecasts for some of the OECD countries, the OECD sees growth this year in the USA at 5.6% and next year of 3.7%. For the eurozone, the respective figures are 5.2% and 4.3%, for the UK 6.9% and 4.7% and for Japan at 1.8% and 3.4%. For China and India, neither being members of the OECD, 2021's growth is forecast at 8.1% and 9.4% (on a fiscal year basis) and for 2022 the respective forecasts are 5.1% and 8.1%. As discussed earlier, inflation will be rising. The OECD sees inflation in the OECD area at 3.5% in 2021 and 4.2% in 2022. And, of course, corporate earnings have reflected the bounce back in economic activity. According to FactSet, US corporate earnings will be up 45% in 2021, with a further rise of 9.2% in 2022, to give just one example. Rising corporate earnings are necessary to sustain share prices after the rises which they have achieved.

We have not drilled down into different countries as we would normally have done in pre-pandemic times because, in our view, market drivers are monetary policy (actions on interest rates and QE) and inflation. We have not yet got into the question of how different countries will address the holes in their public finances, but this will become an issue once the pandemic has, hopefully, settled down into something which can be contained, perhaps with annual vaccinations.

So, after a year when share prices rose, what can we look forward to in 2022? Markets are likely to be more volatile as they deal with, not only, day to day news, good and bad, on the pandemic, but on monetary tightening, which almost everyone expects. If markets are caught out by central banks' tightening policies which are not in line with investors' expectations, there could be bouts of weakness. The course of inflation will dictate their policies, for even the most dovish central bank, the ECB, cannot ignore inflation running constantly above its targets, even though it has specific problems which arise because of the single currency in a monetary union. As we have explained in this review, which is a repetition of a view we have expressed many times, bonds have no attraction to us and they are grossly overpriced, as will be shown when interest rates start to rise. For those investors who do not need to own bonds, they are an asset class to be avoided. Whilst we have allowed cash arising from dividend receipts to build up in our portfolios, this is only where the relevant portfolio is largely fully invested and we would wait for a significant drop in prices to commit the funds. This, however, is only at the margin in an, effectively, fully invested portfolio. Given the economic background, we think that equities remain the best asset class to deal with rising inflation. As the tables at the beginning of this review show, geographical diversification is paramount. 2022 is likely to be a more uneven ride than 2021 turned out to be and it is doubtful if returns at anything like 2021's level can be achieved. If interest rates rise, as expected, value stocks with predictable earnings flows and reasonable dividend yields may come into their own as against growth stocks. With the Federal Reserve becoming increasingly hawkish in its pronouncements, the early days of 2022 have seen a sharp reaction, with some growth stocks falling sharply and value stocks performing relatively well, which appears a sensible reaction to the economic policy outlook. For long term investors, in our view, the danger of being out of the market is greater than being in, notwithstanding our expectation of more volatility and periods of negative performance in 2022.

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