



meridian
ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equity markets have shown a useful recovery in the final quarter of 2022, with many markets moving higher in local currency terms and also in sterling terms, the latter with the notable exception of the U.S.A. Bond markets have been mixed, whilst, in the foreign exchange markets, the U.S. dollar retreated after strengthening earlier in the year. Although disappointing for the year, gold staged a good recovery in the final quarter.

The tables below detail relevant movements in markets :

International Equities 30.09.22 - 30.12.22

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+9.4	+7.1	+15.4	+5.9
Finland	+9.2	+10.4	+18.9	+9.2
France	+12.3	+13.5	+22.3	+12.3
Germany	+14.6	+15.8	+24.8	+14.6
Hong Kong	+17.9	+10.1	+18.6	+8.9
Italy	+16.1	+17.4	+26.5	+16.1
Japan	+3.0	+4.9	+13.0	+3.7
Netherlands	+10.9	+12.1	+20.8	+10.9
Spain	+12.7	+13.9	+22.8	+12.7
Switzerland	+3.8	+2.5	+10.4	+1.3
UK	+9.0	+9.0	+17.5	+7.8
USA	+7.2	-0.5	+7.2	-1.6
All World Europe ex UK	+11.6	+12.0	+20.7	+10.8
All World Asia Pacific ex Japan	+8.5	+4.0	+12.1	+2.9
All World Asia Pacific	+6.6	+4.3	+12.4	+3.2
All World Latin America	+2.6	-1.7	+5.4	-2.8
All World All Emerging Markets	+7.0	+0.8	+8.6	-0.4
All World	+7.5	+2.1	+10.0	+1.0

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.7%

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

Currency	30.09.22	30.12.22
Sterling	4.08	3.66
US Dollar	3.83	3.88
Yen	0.23	0.41
Germany (Euro)	2.10	2.56

Sterling's performance during the quarter ending 30.12.22 (%)

Currency	Quarter Ending 30.12.22
US Dollar	+8.4
Canadian Dollar	+6.2
Yen	-1.8
Euro	-0.8
Swiss Franc	+1.5
Australian Dollar	+1.7

Other currency movements during the quarter ending 30.12.22 (%)

Currency	Quarter Ending 30.12.22
US Dollar / Canadian Dollar	-2.0
US Dollar / Yen	-9.4
US Dollar / Euro	-11.0
Swiss Franc / Euro	-2.2
Euro / Yen	-1.1

Significant Commodities (US dollar terms) 30.09.22 - 30.12.22 (%)

Currency	Quarter Ending 30.12.22
Oil	-2.2
Gold	+9.6

PERFORMANCE DURING 2022

International Equities 31.12.21 - 30.12.22

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+1.5	+6.6	-5.3	+0.9
Finland	-9.1	-4.0	-14.7	-9.1
France	-7.3	-2.1	-13.0	-7.3
Germany	-16.6	-11.9	-21.8	-16.6
Hong Kong	-6.9	+4.7	-7.0	-0.9
Italy	-9.3	-4.2	-14.9	-9.3
Japan	-3.1	-4.8	-15.5	-9.4
Netherlands	-23.3	-19.0	-28.0	-23.3
Spain	-1.9	+3.7	-7.9	-1.9
Switzerland	-16.3	-7.2	-17.6	-12.2
UK	+4.9	+4.9	-6.9	-0.8
USA	-19.3	-9.1	-19.3	-14.0
All World Europe ex UK	-14.5	-9.4	-19.5	-14.3
All World Asia Pacific ex Japan	-12.0	-5.9	-16.4	-10.9
All World Asia Pacific	-9.2	-5.5	-16.1	-10.6
All World Latin America	+4.1	+22.9	+9.1	+16.3
All World All Emerging	-13.5	-6.5	-16.9	-11.5
All World	-15.3	-7.3	-17.7	-12.3

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -23.8%

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

Currency	31.12.21	30.12.22
Sterling	0.96	3.66
US Dollar	1.51	3.88
Yen	0.06	0.41
Germany (Euro)	-0.19	2.56

Sterling's performance during the year ending 30.12.22 (%)

Currency	Year Ending 30.12.22
US Dollar	-10.6
Canadian Dollar	-4.2
Yen	+1.9
Euro	-5.0
Swiss Franc	-9.3
Australian Dollar	-4.7

Other currency movements during the year ending 30.12.22 (%)

Currency	Year Ending 30.12.22
US Dollar / Canadian Dollar	+7.2
US Dollar / Yen	+14.0
US Dollar / Euro	+6.4
Swiss Franc / Euro	+4.9
Euro / Yen	+7.2

Significant Commodities (US dollar terms) 31.12.21 - 30.12.22 (%)

Currency	Year Ending 30.12.22
Oil	+8.3
Gold	-0.8

MARKETS

International equity markets experienced a positive quarter which helped to reduce the overall negative return for the year. Given the geopolitical and economic headwinds, equities put in a creditable performance in the final quarter of 2022.

In local currency terms, the FTSE All World Index showed a total return of +7.5%, in sterling terms +2.1%, in US dollar terms +10.0% and in euro terms +1.0%. Looking at local currency returns first, all of the areas covered in our table showed an impressive return. The strongest area was Europe where the FTSE All World Index showed a return of +11.6% and the strongest market was Hong Kong where the FTSE Hong Kong Index returned +17.9%, a major recovery from earlier weakness. Australia also performed well with the FTSE Australia Index returning +9.4%. Having had a strong run previously, the FTSE All World Latin America Index underperformed this quarter with a relatively modest return of +2.6%. Returns altered significantly when shown in sterling terms. Europe continued to perform very well, returning +12.0% and, because of the strength of sterling, the FTSE UK Index showed a big outperformance against the FTSE All World Index, +9.0% against +2.1%. The FTSE Australia Index was also a strong outperformer, returning +7.1%. A very notable underperformer was the FTSE US Index which showed a negative return of -0.5% in sterling terms. The weakest performance in the table was the FTSE All World Latin America Index which returned -1.7%.

Turning to the international bond markets, and using 10 year government bonds as proxies, the only yield lower than at the end of the third quarter was that of the UK but it started at an elevated level because of the upheavals in the sterling bond market following the badly received UK mini budget in September, which temporarily upended the sterling bond market. The gross redemption yield on the 10 year UK government bond fell by 42 basis points to 3.66%. The yield on the US Treasury crept up by 5 basis points to 3.88%. On the German Bund, the yield rose by 46 basis points to 2.56% and on the yen bond by 18 basis points to 0.41%. As we have mentioned before, the Bank of Japan has been following an idiosyncratic policy of yield control whereby it intervened to keep the 10 year bond yield 25 basis points either side of zero. In December, without warning, it changed the bond to 50 basis points, which many observers took to mean that the Bank of Japan was signalling higher interest rates and a move away from its loose monetary policy, though this was denied by the Bank.

Moving on to the foreign exchange markets, the feature of the quarter was the recovery in the yen, following the move by the Bank of Japan, described above. With the Bank of Japan not previously following other developed markets' central banks in raising interest rates, the yield differences had widened and the currency, accordingly, was weak. Signs of a change in monetary policy, whether true or not, caused a spike up in the currency. A sharp reversal in the strength of the US dollar meant that the two strongest currencies in the quarter after the yen were the euro and sterling. Against the yen, sterling fell by 1.8% and against the euro by 0.8%, but against the US dollar it rose by 8.4% and against the Canadian dollar by 6.2%. It rose against the Australian dollar by 1.7% and against the Swiss Franc by 1.5%.

In the commodity markets, oil, as measured by Brent crude, fell by 2.2%, whilst gold showed a strong recovery, rising by 9.6%.

If we now turn to the year as a whole, not surprisingly, we see a negative performance, given the unexpected (for most people) Russian attack on Ukraine. However, for sterling based investors with an internationally diversified and unhedged equity portfolio, the results were not as negative as media headlines about markets' performance in 2022 would have suggested. In local currency terms, the FTSE All World Index returned -15.3%, in sterling terms -7.3%, in US dollar terms -17.7% and in euro terms -12.3%. We see that the worst performance came from the USA, with the FTSE USA Index returning -19.3%. On the positive side, the FTSE UK Index, with its weighting to value stocks, returned +4.9%. There were also positive performances from the FTSE All World Latin America

Index, +4.1%, and the FTSE Australia Index, +1.5%. We see a different picture in sterling terms as a result of sterling's weakness. The outstanding performer was the FTSE All World Latin America Index with a return of +22.9%, followed by the FTSE Australia Index, +6.6%, the FTSE UK Index, as just mentioned, +4.9%, and the FTSE Hong Kong Index, +4.7%. The FTSE All World Europe ex UK Index was an underperformer, returning -9.4%, as was the FTSE USA which returned -9.1%

If equities show negative returns, normally bond markets would show positive returns, but this was not the case in 2022 and international bond markets experienced a torrid time. Taking 10 year government bonds as a benchmark, the gross redemption yield on the UK government bond rose by 270 basis points to 3.66%, on the US Treasury bond by 237 basis points to 3.88%, on the German Bund by 275 basis points to 2.56% and on the Japanese government bond by 35 basis points to 0.41%.

2022 was a very difficult year for sterling. There was only a positive performance in our table against the yen, against which it rose by 1.9%. Elsewhere, there were declines. It fell by 10.6% against the US dollar, by 9.3% against the Swiss Franc, by 5.0% against the euro, by 4.7% against the Australian dollar and by 4.2% against the Canadian dollar.

In the commodity markets, oil managed a modest rise, +8.3%, whilst gold put in a disappointing performance, given the background, with a return of -0.8%.

ECONOMICS

When we write our end of year review, we find it instructive to look back at what we wrote twelve months previously to see if our views on the forthcoming year were broadly correct, broadly wrong or, more likely, a bit of both. Looking back on 2022, the big story was geopolitical, namely Russia's attack on Ukraine, with its knock on economic effects on inflation.

When we looked forward to 2022, twelve months ago, geopolitical issues were mentioned in the context of Russia and Ukraine and China and Taiwan but, whilst the evidence of a possible invasion of Ukraine was there, not many people believed that it would happen and, similarly, although everyone knew about China's ambitions towards Taiwan, an invasion was not thought to be imminent. So, when Russia attacked Ukraine at the end of last February, it was a surprise to most people and something which the market had not factored in. So, we would determine that the invasion was a "black swan" event in the same way that the emergence of Covid-19 was at the beginning of 2020. We were on more secure ground in expecting that inflation would be an issue in 2022, but were only partly right in determining why it would be a problem. We were correct in believing that the failure of central banks in 2021 to tighten monetary policy enough would lead to inflationary problems in 2022 but, because a Russian invasion of Ukraine and the consequent inflationary economic effects, mainly via energy and food prices, were not factored in, inflation was a much greater problem than expected. So, although we got the direction of inflation correct, we certainly underestimated its magnitude.

We thought that the driver of markets in 2022 would be monetary policy and inflation and that was correct in as far as it went but, because we had not factored in the inflationary consequences arising from Russia's invasion of Ukraine, we underestimated the speed and rate of change in interest rate increases. Because central banks were behind the curve on interest rate increases in 2021, we said that central banks would have to tighten monetary policy. We particularly highlighted the apparent relative reluctance of the ECB to tighten monetary policy but felt that it would recognise the problem and this is what it later did.

Two other points from our review a year ago turned out to be relevant in 2022. We discussed the fact that the actions of the central banks in suppressing interest rates and following a very loose monetary policy generally were negating price signalling messages from markets, so, for example, there were very narrow spreads in the eurozone government bond markets which did not reflect, say, the relative strength of Germany's credit rating against some of the financially weaker members of the eurozone. Rising eurozone interest rates have made price signalling more noticeable in its markets as bond yield spreads have widened. But, perhaps the most notable example of price signalling through the interest rate and foreign exchange mechanism returning, occurred in the UK when Liz Truss, as Prime Minister, and Kwasi Kwarteng, as Chancellor of the Exchequer, attempted to set out a new course for the UK economy based on lower taxes and supply side reforms, with the objective of increasing the UK economy's projected growth rate. The objective must have been right as economic growth is essential to provide higher tax revenue but the problem was, and the reason for the abandonment of the policy, that the bond market would not countenance this policy because the tax cuts were not funded. The sharp temporary rise in bond yields and the fall in the pound meant the policy had to be abandoned. Price signalling is important because it highlights problems in an economy and it is something to be welcomed as it helps to unwind distortions in markets and invites policy corrections. Now that the ECB is reversing course on monetary policy, it will be interesting to see if the yield spreads between various eurozone members' bonds increase as investors ponder different credit aspects of the eurozone members. The ECB has been working on a measure to try to control credit spreads, the Transmission Protection Instrument (TPI), to deal with this potential problem but it is not an instrument which one would expect a central bank to use because it is not its job to determine relative yields. The restoration of price signalling is by no means complete, but early moves in this direction are to be welcomed as a move towards unwinding distortions in financial markets.

We also noted that ultra loose monetary policy encouraged investors to search out for alternative assets in the quest to earn higher returns and, in this respect, we mentioned cryptocurrencies. These have been much in the news recently, following the collapse of FTX Trading Limited which operated a cryptocurrency exchange and crypto hedge fund. Whilst a lot of money has been made by some people in cryptocurrencies, a lot has also been lost. It is a highly speculative area of finance and it is extraordinary how many people have been caught up in it, including well regarded institutions. Cheap money and the search for return have undoubtedly raised interest in cryptocurrencies, but it is worth repeating that these are highly speculative and would not find a place in any Meridian portfolio. They have had a disastrous year.

Because the Russian invasion of Ukraine did not feature in our expectations when we wrote our review a year ago, it was highly likely that our forecasts for the year would be compromised. In terms of asset allocation, we remained negative on bonds because of the danger posed by, what we were certain, would be a rising interest rate environment and we expected volatility in that market. That happened and, for investors in the sterling fixed interest market, it was a very poor year. For unhedged sterling based investors with an international portfolio of equities, most will have seen a negative return, but much less negative than the underlying bond return. Given the extraordinary geopolitical and economic background and, taking into account the strong 2021 performance, the returns should be taken in context. The context is the higher geopolitical risk, accelerated tightening of monetary policy and therefore more competition from fixed interest markets, very high inflation, still some supply chain difficulties and pressure on companies' margins. These would normally have been highly negative factors for equities but they will have benefited from the lack of attractive alternative assets, i.e. bonds, where the mispricing was much more serious than for equities, in our view, if, indeed, equities were mispriced.

Drilling down into more detail in the equity markets, we indicated that, with rising interest rates, value stocks could come into their own against previously high flying growth stocks. The theory behind this would be that value stocks could have more predictable earnings growth whilst some of the growth stocks earnings, say, at the more speculative end of the technology market, could be well into the future. Using a higher discount rate for these future earnings as a result of higher interest rates

would have a disproportionate effect on the shares' net present value, compared with the more visible and certain trajectory of value companies' earnings. This, of course, is a broad generalisation but has been validated by sector share price movements in 2022 in the face of central banks' interest rate policy about turns which have seen them aggressively starting to raise interest rates and tighten monetary policy in other ways.

By way of example, if we look at the S & P 500 Index, the Energy sector, for obvious reasons, has been the stand out performer and there have been relatively good (even if negative in absolute terms) performances from the Utilities, Consumer Staples, Health Care and the Industrials sector, whilst, languishing at the bottom of the sector performance league, have been Communication Services, Consumer Discretionary, Information Technology and Real Estate. Nearly all of the top performers in the S & P 500 Index in 2022 came from the Energy Sector. If we look at the FTSE100 Index in the UK, as well as energy shares, the top performing shares came from the defence, healthcare and financial sectors. But, at the bottom end of the performance tables, there are also companies from the financial sector. Housebuilding shares are prominent, as well as the high growth orientated Scottish Mortgage Investment Trust, previously a high flyer. Amongst the best stocks in the Euro Stoxx 50, we see energy, financial and healthcare stocks, but a larger number of sectors which have contributed to the underperformers.

Before we start to consider what might happen in 2023, it might be instructive to look at where we are now at in terms of inflation and interest rates. In this respect we show the first table below from our December 2021 review and the same table now updated from the end of 2022.

Review December 2021

	Year on Year Inflation	10 year Government Bond Yields	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%

Review December 2022

	Year on Year Inflation	10 year Government Bond Yields (at time of writing - 10.01.2023)	Policy Rate
USA	7.1%	3.58%	4.5%
UK	10.7%	3.59%	3.5%
Eurozone	9.2%		2.5%
France	5.9%	2.80%	2.5%
Germany	8.6%	2.28%	2.5%
Italy	11.8%	4.22%	2.5%

These tables show that real interest rates are still significantly negative which, prima facie, does not make fixed interest or cash investments appealing. There does seem to be a better feeling towards fixed interest securities, probably because the absolute level of yields, as shown by the ten year government bond table above, is considerably higher than a year ago and the negative yields have disappeared. But then, of course, inflation is much higher, so the real negative yield argument does not fall away. Because inflation projections are for the rate of inflation to fall back, bulls of fixed interest securities may look forward to a time when real yields are positive as a result of the fallback in inflation, but we think that there is far too much uncertainty to feel confident about this and there are other factors which weigh against bonds, namely supply issues.

The big change here has been the actions of the central banks which have undertaken a sharp about-turn in their policy decisions. It is one of the major economic surprises of recent times that central banks did not recognise the rising inflationary dangers which were developing in 2021. One word which has certainly vanished from central banks' vocabulary is "transitory", the term used to describe the price pressures caused by Covid-19 induced disruptions to the supply chain. Many people felt that this insouciance towards rising inflation was dangerous and so it has proved, with inflation rising to double figures in some countries. Now, of course, inflation would not have been at this level had it not been for the effect on energy and other commodity prices of the fallout from the Russian invasion of Ukraine, but it would have been unlikely to be as bad as it is now because of the higher base inflation levels which were starting to develop, as shown in the table above for the end of 2021. The screech of the monetary brakes is deafening, even from the formerly very dovish ECB as the central banks raise interest rates aggressively and, at the same time, start to reverse Quantitative Easing (QE) by introducing Quantitative Tightening (QT), whereby they either don't reinvest the proceeds from maturing bonds or actively sell existing holdings in the market. Together with the vast borrowing requirements of governments to fund their budget deficits and the need to refinance existing bond maturities, these actions provide a strong headwind to fixed interest markets. Looking at the Economist Intelligence Unit's forecasts for various countries' budget deficits for 2022, we note that for the USA the forecast is 5.5%, for the UK 6.6%, for the euro area as a whole 4.2% but, within that area, 5.3% for France, 4.1% for Germany, 5.7% for Italy and 4.7% for Spain. Refinancing of maturing debt will also increase the burden on countries' finances, given the increased cost of borrowing. Even if one is sanguine about inflationary pressures easing, the problems of increased supply for the market will be very substantial and will still be there even if inflation falls back.

It may seem strange that central banks are indulging in QT at a time of economic difficulty, but the fact is that the size of their balance sheets exploded during the period of QE as they mopped up fixed interest securities, mainly government ones. Whilst economic confidence was so low, they did not pose any immediate threat to inflation, but the danger is that the bank reserves at central banks get mobilised, causing excess demand against supply availability and exacerbating inflation. Sucking money out of the economy by reversing the process complements the effect of rising interest rates but both methods of tightening monetary policy obviously apply contractionary pressures on the relevant economies.

At the end of December, the Bank of Japan surprised markets by announcing a significant modification of its yield curve control policy. An outlier amongst central banks, the Bank of Japan sought to control the yield on ten year government bonds within a band of plus or minus 0.25% of its target of zero. In December, it announced that it would now allow ten year bonds to fluctuate by plus or minus 0.5% of its target of zero. This had the expected effect of pushing up yields on not only JGBs but other countries' bonds also. The Bank of Japan denied that it was a way of increasing interest rates. The move is likely to have a negative effect on sentiment, but it is justified by inflation at 3.8%, a very high figure by Japanese standards. The outlier nature of Japanese interest rates was also depressing the yen and causing angst in business circles because of increasing input costs. The only central bank apart from possibly the Bank of Japan out of line in not tightening policy is now the People's Bank of China. It has a low rate of inflation but has its own particular set of problems as a result of its idiosyncratic Covid-19 policy involving widespread lockdowns to try to eliminate the disease which

has suddenly been abandoned in the face of protests and now will produce a new set of economic problems.

As a result of central bank communications with markets, we have a fairly good idea of the way forward in 2023, at least for the USA, UK and eurozone. There will be further interest rate increases, probably in steps of 50 basis points, rather than the 75 basis point increases which we have experienced. We know that there will be QT of varying degrees, so monetary policy will continue to be restrictive. An expression currently used widely in monetary policy is “terminal rate”, meaning the peak rates for official interest rates. Current projected ranges are over 5% for the USA, 3.25% to 4.0% for the eurozone and 4.25% for the UK. They will undoubtedly change, but those are the sort of ball park figures bandied around at the moment, meaning that there is a fair way to go yet before possible terminal rates are reached.

The central banks have to weigh the trade off between inflation and economic growth. The feeling is that having been too late in tightening monetary policy in 2021, the central banks are having to act more aggressively to raise interest rates and shrink their balance sheets than they would otherwise have had to do and that they may come down on the side of trying to stamp out inflationary pressures at the expense of economic growth and even recession.

One of the dangers which central banks fear is that inflation becomes embedded in people’s thinking. As we see in the UK and Europe at present, trade unions are pushing for pay increases to keep up with the increased cost of living. The danger is that, if this happens, inflation will become embedded in the system, meaning that central banks will double down on their policy of increasing interest rates and increasing the risk of a recession. “Stagflation” is a word which alarms economists, but the world economy is nearer to it than for a long time and it is not normally a good background for investors.

With the geopolitical and economic background so fluid, economic forecasts are particularly hard to make at present but, to get an idea of what is currently expected, it is worth looking at the OECD forecasts published in November. If we take the G7 countries and look at the relevant forecasts for 2023, we see that growth for the USA is put at 1.0%, for Japan at 1.8%, for Germany at -0.3%, for France at 0.6%, for Italy at 0.2%, for Canada at 1.0% and for the UK at -0.4%. For the eurozone as a whole, the forecast is 0.5%. Elsewhere, China is forecast to grow at 4.6% and India at 5.7%. With the exception of Japan and China, 2024 is expected to produce a better result than 2023, although growth will still be low for the world economy at 2.7% against an expected 2.2% in 2023. 2024 is a long time off and a lot could happen before then, but the tone of the forecasts is unmistakable - growth will be very modest.

One of the worst performing markets in 2022 has been China. Whilst we touched upon it in our review a year ago, it was in the context of a geopolitical risk, namely its increasingly strong comments on Taiwan. Whilst this is always in the back of investors’ minds and, perhaps, increasingly moving towards the front after the Russian invasion of Ukraine, other issues have combined to make it a bad year for investors in China, notwithstanding a recovery towards the end of the year. The strictly enforced lockdowns in China in pursuit of President Xi’s zero Covid policy have had a devastating effect on the economy, as well as being a significant cause of critical supply chain problems for companies around the world. After President Xi obtained a third term in office, popular discontent at the lockdowns caused an about-turn by the Chinese government and now the disease is rampant in China, throwing further doubt on China’s short term growth prospects but, also, with further knock on effects on the world economy through dislocation of the supply chain and reduced Chinese demand for foreign goods. The increasingly nationalistic and interventionist stance of the Chinese government was reflected in its refusal to allow foreign made Covid vaccines to be used in China, which has almost certainly worsened the Covid outbreaks given that western vaccines are considered to be more effective. The private sector has come under attack as part of Xi’s “common prosperity” theme, posing a threat to corporate earnings, so that a number of companies’ earnings have been decimated as a result of official policy decisions. The arbitrary nature of the attacks on businesses has hit some companies’

share prices hard. China has been the subject of increasing western sanctions, notably by the USA, in respect of technology, and there does seem to be an increasing number of reasons why China is less attractive to foreign investors for political and economic reasons than it has been. Whilst President Xi's position has seemed impregnable until recently, the fact that the government has backed down on its Covid restrictions in the face of increasingly vocal opposition to it could be significant. China, as the world's second largest economy, will be at the forefront of investors' attention for geopolitical and economic reasons and there is a possibility that it will be the main influence on markets in 2023.

We have often said in reviews going back many years that politics is as important as economics in determining markets' performances and future outlook. In the immediate aftermath of the Covid-19 pandemic, from February 2020 (the time when it really attracted full attention), and right up to the present day, it has been economics which has been the main influence on markets and, particularly, monetary policy. The development of central banks' policies to deal with rising inflation, initially caused by central banks being behind the curve on tightening monetary policy, and then seriously worsened by the inflationary consequences of Russia's invasion of Ukraine, has been central to investors' thinking. It would obviously be wrong to say that things have settled down in relation to the pandemic, Russia's invasion of Ukraine, inflation and the monetary policy response to deal with it. Far from it, but we can say that it is now a more settled position that investors are coming to terms with, bad though it is, and markets have been more steady of late, although still nervous.

We now think it is time to take into account politics. With inflation very high, growth stalling in some countries and governments' finances seriously weakened, as evidenced in the OECD's economic forecasts quoted earlier, it is not a good time to be in government as governments tend to take the blame, even if it is for matters outside their control. If we relate this problem to the west, we can consider the position in the UK, EU and USA because these areas are where this issue is most relevant. Starting with the UK, which has experienced a particularly turbulent year, Liz Truss's and Kwasi Kwarteng's attempt at a different course to deal with the UK's economic problems led them to be forced out of office and the new team of Rishi Sunak and Jeremy Hunt have concentrated on trying to restore the country's finances by tax increases, which are not conducive to economic growth. Furthermore, they are following policies which one would not normally associate with centre right governments. Besides the restoration of corporation tax increases, which had been planned, the windfall taxes on energy companies have been extended. Whilst, in the short term, these may be popular with voters, the economic consequences of windfall taxes are malign, notably in damaging investment as companies re-evaluate investment projects, not to mention acting as a deterrent to stock market investors. One example of the danger of windfall taxes is shown by Harbour Energy's decision not to bid for new licences in the North Sea. Total Energies also said, in December, that it would cut planned expenditure in UK oil and gas projects by 25% following the increased tax burden on the sector. The point is that measures like this make the UK a less attractive market in which to invest. For private investors and savers, the mini budget brought only bad news with respect to CGT exemption allowances and the dividend allowances. Whilst these unwelcome measures for private investors are unlikely to affect the UK stock market in themselves because they will affect investments wherever they are made, the measures for the corporate sector are the ones which will really diminish the attraction of the UK.

Ideologically, countries in the EU are more sympathetic to measures which raise the burden on the corporate sector and windfall taxes will be part of the EU tax raising measures. For example, Spain plans levies not only on energy companies but also on banks on the basis that rising interest rates will raise their net interest margins. It is not even on profits, it will be levied on their income from interest and commissions.

The contrast with the USA is instructive and, we feel, relevant as far as international investors are concerned. In the UK and Europe, for example, if a government can gain a majority in their legislatures for a policy it will be enacted, but because the President of the USA is in a different position because of the checks and balances in the constitution, his wishes cannot necessarily be enacted into law. So, the recent Congressional elections are important. Whilst President Biden would like to see higher

taxes on businesses and some individuals and has been highly critical of the US oil sector, the loss of the House of Representatives to the Republicans in the recent mid term elections means that tax raising plans are not likely to come to fruition. This deadlocked position is one which investors should welcome because the absence of legislation, particularly any items which they would not welcome, gives more certainty for the next two years and one thing investors do not like is uncertainty.

These points are generalised ones but these simple examples suggest to us the investment background will be more welcoming to investors in the USA than the UK and Europe and that investors should take this into account in their asset allocation. We have important exposure to the USA and it seems more important than ever to maintain such a position as there is less political risk there than elsewhere, in our view.

So, it is easy to construct a bleak outlook for 2023 and we have touched upon some of those issues which contribute to that view, namely the Russia/Ukraine conflict, China (both in relation to the extent of the pandemic, now that the zero Covid policy has been abandoned and, politically, the possible execution of its plans for Taiwan), monetary policy tightening both in relation to interest rates and QT, slow economic growth or recession and inflation. We could add another possible one which is problems in the eurozone arising from its tightening of monetary policy and, particularly for those countries like Italy which are heavily indebted, with outstanding public debt at around 150% of GDP. As in the UK after the mini budget, bond markets may take fright if they feel financial and economic problems are not being addressed.

It is easy to assemble this list of factors which could make 2023 a bleak year economically and politically but, in practice, nothing is ever 100% negative or positive. So what could go right? Apart from the Russian invasion of Ukraine coming to an end and Europe, in particular, escaping blackouts, the main economic hope would be for inflation to fall back from its present highly elevated levels. As the tables earlier in this review show, there is still a large gap between current year on year inflation rates and ten year government bond yields, to give just one yardstick, so the real returns remain significantly negative. It is to be hoped that inflation has peaked, although projected terminal short term interest rates, as mentioned earlier, are well above current official interest rates as central banks indicate further monetary tightening. The shape of the yield curve is interesting when looking at the 2 year government bond yields through the 5 and 10 year maturities out to the 30 year maturities. In the UK, the yield curve is moving in the direction one would normally see, i.e. interest rates rising over the maturities, although the slope is quite gentle, only rising just over 50 basis points between the 2 year and 30 year maturity. One would normally expect a steeper upward sloping yield curve. But, for US and German government bonds, to take an example of the eurozone's strongest credit, the yield curve is sloping downwards across all the maturities from the 2 year yield, except for a slight rise between the 10 and 30 year yield in the US treasury bond market. So, for example, in the US government bond market, the 30 year bond is yielding 54 basis points less than the 2 year government bond and, in the German government bond market, the 30 year bond yields 42 basis points less than the 2 year government bond. Such a downwards sloping yield curve would normally indicate a recession. The oddity is that the UK yield curve may be indicating a better relative position, albeit that the upward slope is not as steep as one would normally expect. In the present circumstances, central banks appear to be emphasising control of inflation over economic growth so that, in their desire to crush inflation, they may well cause a recession, or at least exacerbate weak trends in the economy. Longer maturity bonds are then likely to anticipate lower inflation rates which might be expected to result. However, before that, if central banks act as we may expect them to, the whole yield curve will shift upwards, even if it may still be inverted. The sweet spot is likely to come when markets anticipate that we are near the terminal rate and can anticipate the first reduction in central bank rates.

If one is to invest in equities, one is going to have to want to receive a better total return than on what are traditionally thought to be less risky investments, such as cash or government bonds. We would challenge this view on government bonds (or other fixed interest securities), at a time when artificially low or negative short term interest rates were in existence, because, when monetary policy tightened,

there would be a fall back in fixed interest securities' prices and, if interest rates reverted to more normal levels, would see significant losses or opportunity costs. At the time when central banks' monetary policy was at its loosest, dividend yields on shares significantly exceeded those on 10 year government bonds, to which we were comparing them at the time, and for those who required income that was an important consideration. Because bonds, in our view, were so overvalued, we thought them to be more risky than equities in the sense that, when yields returned to what would be considered a more normal level, there would be significant losses for investors or, at least, opportunity costs, as just mentioned, which they could never recover, whereas equities over time were likely to move higher as, in the worst case, they were not so overvalued.

Now, if we look at these three countries' equity data (10.01.23), in the UK, the dividend yield on the FTSE 100 Index is calculated at 3.04% and on the 10 year bond at 3.59%, so it is marginally better. On the DAX, in the German market, the dividend yield is 3.52%, well above the 10 year government bond yield of 2.28%. In the US market, however, the situation has reversed, with the dividend yield on the S & P 500 at 1.73%, well below the 3.58% on the 10 year government bond, so that is a more challenging relationship. One can still make a good case for the US equity market in terms of projected price/earnings ratios. Projecting forward, the earnings yield (the reciprocal of the price/earnings ratio) on the S & P 500 Index is around 6.4, so well ahead of the 10 year government bond yield. Of course, that is a function of the S & P 500 Index falling back in 2022 at a time when corporate earnings have held up, but the relationship between equity and bond yields is acceptable in terms of justifying the holding of US equities.

How do we distil all these factors into making a coherent justification for our investment policy which favours equities? After all, the immediate geopolitical and economic situation looks grim. However, the first thing to say is that current circumstances do not necessarily read across to securities markets, which look ahead. The second point to make is that one has to invest somewhere. Looking at mainstream assets, cash, fixed interest and equities (which would include property via, for example, real estate investment trusts) we feel that equities have more advantages. With cash, one is certain to lose money in real terms, given the absolute level of interest rates and the current and prospective inflation rates. Whilst fixed interest securities are probably not as mispriced as they were, assuming inflation falls back significantly, yields, in our view, remain unattractive and, as 2022's losses show, cannot be considered a low risk investment. Whilst many companies continue to face difficulties in obtaining supplies and significant input inflation, profits and dividends are not in danger of collapse. It is true that economic growth worldwide is going to be weighed down by the substantial amount of extra debt taken on during the pandemic and huge energy price subsidies as governments have to pay additional servicing costs, not only because of the size of the debt but also because the cost of servicing the debt is rising as interest rates increase. However, there is no reason to believe that the world economy will not be able to resume its growth trajectory, albeit at a more modest pace for the reason mentioned above. As in the past, we would expect this to be reflected in higher equity prices. We are always aware, when reviewing investment policy in difficult economic or geopolitical times such as the present, that it is more embarrassing to be highly liquid as a result of market sales made because the background is so awful (the outbreak of the pandemic in February 2020 for example) and then stranded with cash when markets recover and move ahead, than remaining relatively fully invested through the setbacks. Even during these bad times, dividends are being received and one does not risk suffering the opportunity cost when prices recover. Those who have reacted to bad news by selling good quality equities and being too liquid when the equity markets recover, may never make up the returns they will have forgone.

With so much geopolitical and economic uncertainty, we must expect markets to be choppy and quite volatile at times in 2023 as they react to good and bad news. Despite the price falls in 2022, we are still not attracted to fixed interest securities because, even though central banks have started their journey to normality, nominal yields are not yet realistic against the background of significant negative real yields and a poor technical background with so many bonds coming on to the market. Equities, which have held up relatively well in 2022 even though showing, in some cases, significant

negative real returns against such an unexpectedly bad background, we think continue to give the best prospects amongst the standard investment alternatives. However, as our review states, we think that investors should give increased attention to political risks in Europe and the UK where populist policies, which threaten medium and long term danger to their economies, are increasingly being pursued at the expense of their respective economies' investment attractions. In the USA, however, with Congress split, the chances of damaging economic decisions being legislated have lessened and more visibility on legislative action (i.e. not much being done which can damage companies and markets) can only be helpful for investors.

Investors must expect uneven quarterly performances in 2023 because of the geopolitical and economic background, but much of this should be factored into share prices already. Unexpected news, good or bad, is likely to influence markets, so we may expect significant volatility at times. Nevertheless, a geographically well diversified and unhedged equity portfolio still remains our preferred policy. Although equities are not necessarily a hedge against inflation, history shows that long term inflation-adjusted returns are attractive.

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