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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

After positive returns in 2021, markets turned weaker in January as investors absorbed the worsening inflation outlook and its potential effects on the pace of monetary tightening. Volatility increased sharply. None of this was unexpected. Bond markets were naturally affected and yields remain completely out of line with the fundamentals. Currency movements were modest with the US dollar performing well over the quarter.

The tables below detail relevant movements in markets :

International Equities 29.10.21 - 31.01.22

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	-4.0	-8.0	-10.0	-7.1
Finland	-1.2	-2.2	-4.3	-1.2
France	+1.7	+0.7	-1.5	+1.7
Germany	-2.3	-3.3	-5.3	-2.3
Hong Kong, China	-5.0	-3.1	-5.2	-2.1
Italy	+0.8	-0.2	-2.4	+0.8
Japan	-4.8	-3.7	-5.8	-2.7
Netherlands	-11.7	-12.6	-14.4	-11.7
Spain	-3.7	-4.6	-6.7	-3.7
Switzerland	-0.3	-0.1	-2.2	+1.0
UK	+3.8	+3.8	+1.6	+4.8
USA	-2.9	-0.8	-2.9	+0.3
All World Europe ex UK	-2.5	-3.7	-5.7	-2.7
All World Asia Pacific ex Japan	-4.3	-3.7	-5.7	-2.7
All World Asia Pacific	-4.5	-3.7	-5.7	-2.7
All World Latin America	+6.9	+13.4	+11.0	+14.6
All World All Emerging Markets	-2.5	-0.4	-2.5	+0.7
All World	-2.5	-1.2	-3.3	-0.2

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -3.8%

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

Currency	29.10.21	31.01.22
Sterling	1.03	1.30
US Dollar	1.55	1.78
Yen	0.09	0.17
Germany (Euro)	-0.11	0.01

Sterling's performance during the quarter ending 31.01.22 (%)

Currency	Quarter Ending 31.01.22
US Dollar	-1.8
Canadian Dollar	+0.8
Yen	-0.9
Euro	+1.1
Swiss Franc	-0.5
Australian Dollar	+4.5

Other currency movements during the quarter ending 31.01.22 (%)

Currency	Quarter Ending 31.01.22
US Dollar / Canadian Dollar	+2.4
US Dollar / Yen	+0.9
US Dollar / Euro	+2.9
Swiss Franc / Euro	+1.4
Euro / Yen	-1.9

Significant Commodities (US dollar terms) 29.10.21 - 31.01.22 (%)

Currency	Quarter Ending 31.01.22
Oil	+6.2
Gold	+0.5

MARKETS

International equity markets have experienced a modest setback this quarter. In local currency terms, the total return on the FTSE All World Index was -2.5%, in sterling terms -1.2%, in US dollar terms -3.3% and, in euro terms, -0.2%. The two stand out markets on the positive side were the FTSE All World Latin American Index and the FTSE UK Index with returns of +6.9% and +3.8% respectively. Most other markets experienced negative returns, but not significantly so. In sterling adjusted terms, the FTSE All World Latin America Index experienced an even higher return than in local currency terms, +13.4%, but other areas showed negative returns other than, of course, the UK, where value stocks, long shunned by many investors, enjoyed strong returns, matching the profile of the UK market. The worst performance in individual country terms, other than those subsumed in a regional index, was Australia, where the return on the FTSE Australia Index was -8.0%.

International bond markets suffered a poor quarter as interest rate and inflation fears gathered momentum. Taking ten year government bonds as a benchmark, the gross redemption yield on the UK government bond rose by 27 basis points to 1.30%, on the US Treasury bond by 23 basis points to 1.78% and, on the Japanese Government Bond, by 8 basis points to 0.17%. The gross redemption yield on the German Bund turned positive as it rose by 12 basis points to 0.01%.

Currency movements were mixed. Against the Australian dollar sterling rose by 4.5% and against the Canadian dollar by 0.8%, but it fell 1.8% against the US dollar, 0.9% against the Yen and 0.5% against the Swiss Franc.

In the commodity markets, oil, as measured by Brent crude, was firm, rising by 6.2%, but gold was little changed, rising by 0.5%.

ECONOMICS

It is not difficult to find a good quote on the subject of change. Going back some time Heraclitus opined that “Nothing endures but change” and despite all of the change in the world since, the quote endures, which somewhat undermines the quote itself. In the context of this economic memorandum there is perhaps one thing more significant than change and that is, without wishing to be obtuse, the rate of change of change. There is doubtlessly a better way of expressing this but the nub of the point being made here is that when things change at a slow, predictable rate then it is well within our means to manage and plan for that but the two main issues on the table at present are the sudden emergence of a new virus that has claimed millions of lives and the consequences of that, being a snap recession, leading to a sponsored recovery with attendant excess inflation. It is worth reflecting on what has happened to get us to this point and what may happen next.

The origins of the COVID-19 virus remain something of a mystery and it was exactly two years ago in January 2020 that the media were showing images of abandoned central highways and the heart of Wuhan deserted, as a city with a population of over 10 million went into lockdown and remained so for three months. At the time it was easy to observe how the Chinese could take such an action and think how unlikely it would be that a western city such as London would suffer such a fate. That naivety was subsequently reflected in a 25% fall in world equity markets over 25 days between 20th February and 16th March; it’s also worth highlighting that despite this precipitous fall, the FTSE All-World index still achieved a total return, in sterling terms, of 13.0% over the calendar year.

The point being made here, and which will be made later in the memorandum, is that market reaction is often more driven by the perception of risk and there is nothing more unsettling than sudden, unanticipated news which bears unmeasurable consequences. Markets recovered in 2020 and continued to move higher into new territory in 2021, more than in part because the coordinated and instant response from central authorities was of a size that matched or exceeded the threat. It is perhaps more accurate to say that policy decisions have matched the size of the threat so far as we all remain cognisant that, two years on, there are, perhaps, a few more chapters to write, though the approach that countries will take from now is likely to be much more 'live with' than 'live through' COVID.

The truest measure of this pandemic can only really be the human cost, whether that be death, bereavement, ill health or the financial hardship caused by the disruption, but the purpose of this memorandum is to consider the overall economic effect of the virus. A more clinical measure of the last two years is the size of the response. Trillions of pounds have been distributed to individuals, households and companies through financial support schemes and job retention schemes and, in the main, this has been funded by new government debt. These distributions have led to larger budget deficits which in turn have led countries to turn to the bond markets to borrow money to fund the spending. The OECD estimated in 2021 that by the end of 2022 the ratio of government debt to GDP would rise, on average, by 20 percentage points. This level of rise is unprecedented in peace time and at some point it will need to be addressed. This will be easier for some countries than others.

Despite the increase in the supply of debt, prices remain near historic highs and, at the time of writing, there are still over \$8.2 trillion of bonds that have a negative yield, meaning in nominal terms, even allowing for the coupons [interest payments] received over the time held, the holder will receive back less than was paid on the purchase date. Then, on top of that there is the effect of inflation, meaning that the loss will be far larger than the nominal loss when money with reduced buying power is paid back at the point of the redemption or sale of the bond. Bonds on a negative gross redemption yield are noteworthy because it appears perverse to *pay* a borrower for the privilege of providing lending. In fact there is an element of psychology at play here because the difference between a yield of -0.01% and +0.01% is the same as, say, 1.92% and 1.94% but somehow it carries more significance as it is a (very small) guaranteed loss. It is clear that trillions more of 'higher' yielding bonds, still returning a low single digit percentage return offer almost equally bad returns. Returning briefly to the figure of \$8.2 trillion, large by any measure, it is dwarfed by the figure of \$16.5 trillion of bonds on a negative yield less than six months earlier. Rolling back the clock a further seven months the all-time high (or low?) of \$18.2 trillion of debt was on a negative gross redemption yield. The trend is telling but the position suggests there's still a long way to go.

In considering the demand factor in pricing and putting to one side 'Greater Fool Theory' which surmises that it doesn't matter what you buy at whatever price, as long as you are confident that someone will pay a higher price for it then a profit is guaranteed, there are probably four explanations as to why the market is so expensive that the return, if held to maturity, will be so staggeringly poor. The first explanation is that the market knows something that others don't and believes that inflation will fall so significantly that the overall return will prove to be attractive in relative terms. The second hypothesis is that demand in the market is dominated by so-called forced buyers who have little or no choice but to buy the assets. The third explanation is that there are buyers who have little or no interest in the return generated by being bond holders and the fourth is that bond holders can borrow the money somewhere more cheaply which, in the case of negative yields, means that they are being paid to borrow the money and then can park the borrowings in low risk bonds and still make money. There is every likelihood that the first option disappplies. When inflation touches 7%, as it did in United States in December and over 5% in the eurozone in January then, unless it proves to be exceedingly short lived, the return cannot be attractive. The concept of a forced seller is easier to imagine than a forced buyer and yet banks, insurers and re-insurers as well as pension funds, bond funds and ETFs can be forced buyers as they either buy bonds through mandate, regulatory pragmatism or

asset/liability matching. In the long bull bond market of the past 40 years that has not been a problem as returns have been healthy but it will be harder from here. Then there is the role of central banks whose suppression of interest rates and bond yields has been deliberate. It has been in everyone's interest for liquidity to remain high and for companies and governments to have easy access to credit to continue functioning through the pandemic and all leading economies feature a central bank that has shown little restraint in buying its national debt, mortgage-backed securities or that of leading corporates. Those central banks do not consider the ownership of these bonds as a matter of profit or loss but, rather, as instruments for the greater good. Whilst one department of those central banks is administering the purchase of trillions of dollars of bonds, another has provided cash support for banks via cheap funding. The intention was that banks would be able to draw on these cash resources to lend on to their clients in order to keep businesses afloat. In many cases the money found its way into bond purchases which sat, profitably, on the balance sheet of the commercial banks.

Bond markets, in the main as a result of the well-intentioned intervention of central banks, have been pushed to a point where only one outcome seems possible and the speed at which prices fall (and yields rise) will dictate the size of the story it creates. Losses are likely to be significant but if spread over a long period across well-funded institutions the pain will largely be dissipated but that may not apply to individuals with bond exposure. In some ways the better the post-COVID economic recovery, the more invidious the position of central banks. Greater pressure to raise interest rates in the face of inflation will create greater downward pressure on bond prices. An adjustment is sure, the question is how much pain will be associated with this.

Should we be surprised by the rate of increase of inflation over the last eighteen months? We have monetary policy that has not been adapted to a rapidly changing economy. It could even be argued that the speed with which inflation has risen endorses the existing body of evidence of monetary policy being a guiding hand that can either hold back an economy accelerating at an unwise pace or encourage it forward when recessionary forces are at play. We are now, still, experiencing interest rates (real and nominal) that should be expected in the coldest, darkest days of recession. They remain at or near historic lows at a time when economic growth is strong. A not-totally-representative example is the French economy which grew by 7% in 2021, the highest rate of growth since 1969; it followed a contraction of 8% in 2020. The interest rate for the eurozone has not changed since 2019 and, like elsewhere, quantitative easing remains.

Those that operate the levers of power in central banks have good reason to rate their own performance quite highly over the last couple of decades. With independence has come a voice which has gained authority and whose track record can be measured in terms of financial stability and reference to targets. The Achilles heel of any currency is high inflation and it takes a moment or two, and a long memory, to think back to a time when this was a serious economic threat. Deflationary macroeconomic factors have made their job easier as it is now possible and quite acceptable to buy an Audi car that was built in Slovakia or a hard drive for your computer that was made in the Philippines and mobility of labour has increased by a large factor so that its demand is met wherever it is needed, to a greater degree than ever before. To an extent, these two will also go into reverse as pressure grows to reduce the volume of goods shipped around the world and just-in-time manufacturing has been caught out by supply chain frailties. Mass migration is also meeting growing political resistance. We are likely to see a number of steps in the coming years regarding inflation. We saw in December Chair of the Federal Reserve comment that this might be a good time to drop the word 'transitory' when talking about price rises. It is likely that central banks will consider inflation as a more embedded phenomenon which will lead to a more pragmatic approach than having rigid fixed inflation targeting. The trend will be for increased willingness to tighten monetary policy, be it interest rate rises or quantitative tightening and, finally, it would seem likely that wider acceptance of target-busting inflation becomes far more customary.

This piece opens with some focus on the bond markets as the return they generate is directly affected by changes in interest rates and inflation and concerns we see now about the rate of change of inflation and interest rates push the bond market into the spotlight as something to be concerned about for a number of reasons. Firstly, the size of the market. Looking at just the US market, fixed income investments which are issued by companies, local governments and the Treasury amount to over \$50 trillion in 2020, the last available figure. The only way that unimaginably large number can be put in perspective is by comparing it with measures of the same from years past and in 2010 it was \$30.5 trillion and in 2000 it was \$16.1 trillion. This steep upward trend is by no means limited to the United States and is mirrored in the markets of other almost all other countries. Secondly, the conditions that have prevailed over the market over this period have been largely benign. The perfect conditions for bond market growth are low inflation and falling interest rates as the former flatters the real return of capital at maturity and the latter makes the regular payments from the bond more attractive relative to similar floating rate investments, such as money at bank. It should not come as a surprise that interest rates are rising as nobody was expecting inflation to have permanently disappeared but what is eye-catching is the ferocity with which it has returned. The Federal Reserve is now playing catch up and in its January meeting it concluded that it would “soon be appropriate” to start raising interest rates, confirming what most in the market believe to be necessary. This may take the shape of a ¼% rise in March, possibly more, and potentially up to four more later in the year; it also said it would cease net asset purchases of government debt in the secondary market. Central banks are disavowing themselves of the view that inflation is transitory or, perhaps, they always thought that but were limited in the speed with which they could be seen to change their views on interest rate trajectories for fear of causing panic. The market looks to the central bank and the central bank looks to the market. It now looks quite clear that economies such as America’s are running at capacity and a smaller work force and supply constraints may be more enduring than is helpful. Also, unhelpfully, whilst nominal interest rates haven’t changed, higher inflation means that real interest rates have become more negative so it will take a number of interest rate rises to offset this and to achieve the end goal of the change in direction of monetary policy.

Here again volatility in markets arises as the rate of change increases. Looking at the benchmark 10 year US Treasury, following the Federal Reserve’s November meeting it was offering a gross redemption yield of 1.35% and was trading around \$100. At the end of January it was offering a higher gross redemption yield of around 1.80% which corresponded to a market price around \$96. A 4% loss of value in a risk free asset is significant, particularly because of the rapidity of the fall but given the new persistence of inflation and the downward movement in real interest rates there are good grounds to envisage further losses until the price and corresponding yield offer an attractive and realistic lifetime return on the bond.

It would be wrong to devote this memorandum exclusively to the bond markets, though the fundamental changes in the level of supply and demand across the various strata of the market may lead to uncomfortable news stories, unprofitable positions and defaults and, possibly, mis-selling claims. How will equities fare if this is the new normal?

Perhaps a starting point in the answer to this question is looking at how equities have performed in the short period since their early December 2021 high. Of the world’s leading markets the FTSE100 performed relatively strongly with a total return in sterling being around +1.9% (8th December to 31st January). The FTSE All-World Index (total return in sterling) returned -5.2% and the NASDAQ Composite Index returned -13.7%, again as a total return in sterling. Looking within the FTSE100 during that period we find that banks, oil companies and tobacco companies occupy six out of the top ten best performers and carry heavy weightings in the index. These are companies that are all cash generative and with strong free cash flow and have, more than many others in the index, an ability to price in inflation to their models; banks will enjoy an improved net interest rate margin as rates rise and oil companies are enjoying bumper profits as the price of crude has leapt and it is, of course, a large component of current inflation. For a long time the UK market has been out of favour and has

underperformed other markets as its mix of such companies - dependable and high yielding on one hand but not exciting, have been eclipsed by the high growth allure of tech stocks. As a trade, high tech has been exceedingly rewarding but the fall in the NASDAQ index suggests that companies trading on expensive multiples, often whose promise lies sometime in the future are less favoured in times of high inflation and rising interest rates. Manageability of debt and costs also plays into this performance dichotomy as interest rates rise in tandem with inflation.

The wider perspective on this short term trend is the relative performance of value stocks versus growth stocks. The theory is that when times get tough, such as towards the end of the economic cycle as an economy approaches peak boom, interest rates will rise in response to higher demand-led inflation and, as the economy slows, defensive stocks such as utilities, consumer staples and pharmaceuticals will be best placed (but may still incur share price falls). Banks and oil companies are not in the defensive category but a majority of cyclical companies which typically would perform well in times of economic growth not contraction. This is encouraging as it implies confidence among investors of a strength in the economy. We currently find ourselves in a strange part of the economic cycle, affected greatly by the pandemic where, ironically, there is a feel-good factor encouraging consumers to spend. High levels of demand caused by the deferred spending of the pandemic are meeting restricted supply, also created as a consequence of the enduring pandemic. The current read is that companies that are naturally able to adapt to a changing view on interest rates and inflation are in favour.

Classic portfolio construction would allocate money to bonds and equities perhaps 60/40 or 40/60 on the basis that in more cases than not their performance would complement each other. Meridian would certainly not be alone in choosing not to buy bonds for its clients, unless mandated otherwise, and weightings for the bond element of portfolios are sure to have fallen globally but statistics on this are hard to find. Bonds trade in a competitive market and, just like any other asset, at some point the price will fall to a point that the yield is attractive. Putting credit quality to one side the ultimate measure of the attractiveness of fixed interest securities is, allowing for inflation, what total return will be achieved over a period of time on an annualised basis; real interest rates inform this calculation significantly. It is exceedingly unlikely that we will reach that position in the next few years as it would seem likely that there is only a certain speed at which bond prices will be allowed to fall. This is a consideration that central banks will not forget as maintaining financial stability is a core policy requirement of their mandate and a bond market collapse would be in nobody's interest.

Perhaps the two most important tenets of investment are to look to the longer term beyond short term volatility and to remain diversified and there is now over 100 years of accurate historic market data that informs and supports the approach. At this particular time, with economic growth still high and companies, in the main, reporting strong revenue growth there are good grounds to remain cautiously optimistic that a diversified portfolio of equities will enjoy positive real gains over the medium term though negative short term periods are a distinct possibility. These concluding comments have been repeated many times in this economic memorandum. Some things don't change.

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