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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

As this is written in the first week of August, markets have seen a spectacular turnaround as worries about the US economy and the booming tech sector have caused equities, particularly in the tech sector, to reverse the previously strong trend. But, up to the end of the latest quarter, international equity investors had seen good performances and bond investors, too, had benefited from a fall in yields. In the currency markets, sterling was generally stronger. It remains to be seen if the sell off in markets at the beginning of August is anything but a temporary setback following a strong run. As our review will show, we continue to favour equities as the asset class to hold for the long term.

The tables below detail relevant movements in markets :

International Equities 30.04.24 - 31.07.24

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+6.7	+4.4	+7.3	+6.0
Finland	+1.0	-0.4	+2.2	+1.0
France	-3.1	-4.4	-1.9	-3.1
Germany	+3.8	+2.4	+5.1	+3.8
Hong Kong	-3.9	-6.2	-3.8	-4.9
Italy	+3.0	+1.6	+4.3	+3.0
Japan	+1.7	+3.7	+6.4	+5.1
Netherlands	+2.1	+0.8	+3.4	+2.1
Spain	+3.0	+1.6	+4.3	+3.0
Switzerland	+8.8	+10.5	+13.4	+12.0
UK	+3.6	+3.6	+6.3	+5.0
USA	+10.0	+7.2	+10.0	+8.7
All World Europe ex UK	+2.9	+2.1	+4.7	+3.5
All World Asia Pacific ex Japan	+5.9	+3.4	+6.0	+4.8
All World Asia Pacific	+4.4	+3.5	+6.2	+4.9
All World Latin America	-0.7	-10.7	-8.4	-9.4
All World All Emerging Markets	+5.7	+2.3	+5.0	+3.7
All World	+7.6	+5.5	+8.2	+6.9

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +3.9%

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

Currency	30.04.24	31.07.24
Sterling	4.35	3.97
US Dollar	4.68	4.03
Yen	0.87	1.05
Germany (Euro)	2.58	2.30

Sterling's performance during the quarter ending 31.07.24 (%)

Currency	Quarter Ending 31.07.24
US Dollar	+2.9
Canadian Dollar	+3.1
Yen	-2.1
Euro	+1.4
Swiss Franc	-1.7
Australian Dollar	+1.8

Other currency movements during the quarter ending 31.07.24 (%)

Currency	Quarter Ending 31.07.24
US Dollar / Canadian Dollar	+0.4
US Dollar / Yen	-4.4
US Dollar / Euro	-1.2
Swiss Franc / Euro	+3.0
Euro / Yen	-3.2

Significant Commodities (US dollar terms) 30.04.24 - 31.07.24 (%)

Currency	Quarter Ending 31.07.24
Oil	-6.8
Gold	+2.4

MARKETS

It has been a profitable quarter for equity and fixed interest investors. In the international equity markets, the FTSE All World Index showed a total return in local currency terms of +7.6%, in sterling terms of +5.5%, in US dollar terms of +8.2% and, in euro terms, of +6.9%. Looking at local currency returns firstly, the stand out performer was the USA with the FTSE USA Index returning +10.0%. On the other side, the FTSE All World Latin America Index showed a return of -0.7%. Indices showing positive, but underperforming returns, included the FTSE All World Europe ex UK Index, +2.9%, where the inconclusive results of the French elections impacted the French stock market, and the FTSE UK Index, +3.6%. Turning to sterling adjusted returns, the FTSE USA Index also showed a significant outperformance against the FTSE All World Index's return of +5.5%, returning +7.2%. Of most note was the effect of currency weakness on the FTSE All World Latin America Index which showed a negative return of -10.7%. Severe weakness in the Mexican and Brazilian currencies in particular made a large impact on the sterling adjusted return.

Turning to international bond markets, where sentiment has suddenly shifted from pessimism about the scale and timing of interest rate reductions to more optimism, we note a good outcome over the quarter. Looking at ten year government benchmark bond yields, the UK gilt's gross redemption yield showed a fall of 38 basis points to 3.97% whilst the US Treasury bond's gross redemption yield fell by 65 basis points to 4.03%. The gross redemption yield on the German Bund declined by 28 basis points to 2.30%. The exception was Japan where tighter monetary policy saw the gross redemption yield on the Japanese Government Bond rise by 18 basis points to 1.05%.

In the foreign exchange market, sterling was generally firmer. Against the Canadian dollar, it rose by 3.1%, against the US dollar by 2.9%, against the Australian dollar by 1.8% and against the euro by 1.4%. On the other hand, a sharp snap back by the Yen saw sterling fall by 2.1% against it. Against a resurgent Swiss Franc, sterling fell by 1.7%.

In the commodity markets, oil, as measured by Brent crude fell by 6.8%. Gold continued its strong performance and rose by 2.4% with China being one of the rumoured buyers as well as wealthy individuals seeking a protection from any fall out from the geopolitical turmoil.

ECONOMICS

Charles Dickens, for a number of reasons, had little understanding of the sensitivities of sovereign debt management but, like most of us, had little need to. The simplest measure of a country's success at managing its borrowings is how many times, if at all, it defaults on its debt. In modern times a sovereign default of a leading economy is almost unheard of and markets often refer to such high quality debt as risk-free, though 2022 proved that risk-free does not mean loss-free but whether one equates to the other is a matter for discussion elsewhere. Wilkins Micawber did warn us that "Annual income twenty pounds, annual expenditure nineteen, nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds, ought and six, result misery".

It is sometimes observed that countries never repay their debt but simply roll it over and rely on a growing economy to diminish the burden it creates. The period of economic expansion following the Second World War validates this and using the United Kingdom as an example, government debt stood at around 270% of GDP in 1946, or, £27 billion. Over the next 30 years the figure had increased to £64 billion in nominal terms. That £37 billion increase was almost entirely due to the issuance of fresh debt to cover interest payments as spending by successive governments created, on average, a surplus (taxes raised exceeded spending) of 1.6% per year. At this point the story looks far from rosy but over those 30 years the economy grew, in nominal terms again, by 8.8% per year. Put another way, the British economy in 1946 was worth around £10 billion but by 1976 it was £131 billion. It's important to note that the 8.8% nominal growth comprised 2.3% annual real growth and 6.5% whole economy inflation. As the rate paid to bondholders on the debt was, on average, 3.6%, it's easy to see how Mr Micawber would have been happy if he knew his income would grow faster than his outgoings.

We now find ourselves in very different times. The levels of national debt are much lower than they were 80 years ago but much higher than they have been since those years after the Second World War. Various factors come into play in considering how manageable the position is for today's finance ministers. Putting to one side the factors that have led countries to be so indebted (Global Financial Crisis and COVID spring to mind) where do we go from here?

Figures vary but here is a table of 2024 levels of debt and current government deficits.

Country	General Government Debt	Fiscal Balance
World	75%	-4.9%
Canada	107%	-1.1%
France	111%	-4.9%
Germany	64%	-1.1%
Italy	137%	-4.6%
Japan	264%	-6.5%
United Kingdom	98%	-4.6%
USA	122%	-6.5%

Whilst debt levels are high by any measure, markets are not pricing in any sense of panic and the greatest levels of concern are for those countries that will find it difficult to improve their fiscal balance. These are difficult times for governments to cut budgets or raise taxes and a more palatable proposition is to promise growth. Looking around the eurozone, because comparisons are more straightforward as they share a currency, the cost of borrowing from the market does not automatically follow the credit ratings of the sovereigns. Looking at 10 year yields (as at 5th August), Germany (AAA rated) 2.16%, Netherlands (AAA) 2.47%, France (AA-) 2.97%, Spain (A) 3.12%, Portugal (A-) 2.91%, Italy (BBB) 3.66% and Greece (BBB-) 3.31%.

Perhaps the most anomalous yield (given its credit rating) is France having to pay an annualised 2.97% to borrow for 10 years meaning its costs are closer to Greece's than Germany's, higher than Portugal's and pretty much halfway between Germany's and Italy's. Credit ratings will continue to change but yields in the market are, to use a July 2024 analogy, like goals in football, the only measure that counts. What the market likes is countries whose governments are committed to fiscal tightening and have some track record. After the inconclusive election in France in July which effectively

resulted in a three way tie, the most probable outcome is some sort of alliance of the left with the survivors of Macron's party, Renaissance, as nobody is prepared to work with the right wing party of Marine Le Pen. There is much political will, on the right as well as the left, to make policy decisions that on one hand would be popular with the electorate but on the other unpopular with the markets, which decide the cost of borrowing to fund them.

The European Commission also has issues with the French government and it confirmed in June that it is recommending that France and six other countries (Belgium, Hungary, Italy, Malta, Poland and Slovakia) take corrective action as they are breaching the bloc's fiscal rules. The mechanism that applies is the Excessive Debt Procedure (EDP) and it relates to the national budget and a country's ability to balance the books. Government spending can't exceed tax receipts by much for long without Brussels becoming concerned, hence this procedure and it is designed to, first, encourage countries to trim their spending or raise taxes but can result in fines, which would not immediately help the problem and could be as much as 0.2% of GDP while countries in receipt of assistance from the European Structural and Investment Funds may face a temporary suspension of this financing.

All of this comment on sovereign debt markets has more than a passing relevance to portfolio management in that bond markets price off risk-free yields. An investor will not buy a bond from a corporate borrower for the same return as from a sovereign issuer because if the returns were the same, any sensible investor would seek out the best risk/return trade off and buy the government bond. If government debt falls in value, and consequently its yield rises, then it ripples all the way down the risk ladder and Meridian would not be the first to observe that bond markets of the last three years are far more turbulent places than they were for half a century before. The house view is that the uncertainties around bond markets will continue to detract from including bonds in client portfolios for a number of reasons. As explained above, the sovereign debt market is in a period of expanding supply, deteriorating creditworthiness, uncertain political direction and undergoing a reversal of the decade of quantitative easing that led central banks to buy up trillions of dollars/pounds/euros/yen/other of bonds meaning that the biggest bond buyers in history are now completely absent from the market. The pain felt by bond markets by the surge in inflation and sharp rise in interest rates was most acute in 2022 and rates have all but peaked yet bond markets have had an uncertain first half of the year as central banks hesitate for fear inflation is not yet beaten.

The striking difference between this current period of high indebtedness and the one which followed the 1939-1945 war is that there was a realism following the war that it would be a time of austerity. Inflation was, historically, much higher than is considered acceptable now and sensitivities around falling standard of living now create tensions that play out at every General Election. The reach of the State is forever greater and the need for the country to provide services that the private sector can't or won't seems to grow by the year.

The dust is settling following the UK election with much being made of the need to put the interests of the country first and politicians of all persuasions aiming to convince the electorate that prudence around the public purse is paramount. The new Chancellor has pledged "iron clad" fiscal discipline, which markets like but, as we have observed, spending is a function of income and so the rate of economic growth is an important consideration. The new government has expressed its ambition to lift UK growth to 2.5% per annum but only modest improvements to the Bank of England's growth forecasts on 1st August, raising it to 2.0% show that it is going to be a hard task. The views of other interested parties are of value and the International Monetary Fund estimates that a growth rate of 2.6% is needed to meet the three ambitions of maintaining fiscal discipline, limited tax rises and better public services.

Yields on UK debt did not move significantly over the General Election period which is encouraging as markets react very poorly to uncertainty. This was well illustrated by Liz Truss during her 49 days in Number 10 and perhaps a picture of Liz Truss should be hung on the wall of 11 Downing Street as an aide-memoire to all future Chancellors. The debt dynamics of UK are a long way from ideal and

will be a constraint on the intentions of any government in power but the Global Financial Crisis and COVID have added enormous budgetary pressures to all leading economies.

In terms of the relationship between UK economic growth and the portfolio management that Meridian undertakes, it must be said, there is only a small correlation. The reason for this is that United Kingdom now represents around 3.3% of the world economy yet that's still enough to put it in the top six of country economies. Measured in Purchasing Power Parity, which adjusts exchange rates so that the currency of any country has the same buying power in another country, the UK drops to 2.2%. Clients will know that it has been Meridian's preference to invest internationally and to treat the UK as one constituent part of the world, sized accordingly. Of far greater interest is the growth rate achieved by the United States and, increasingly, developing markets such as China and India. The best performing developed market over the past five years has been America's and this reflects the quality of its best companies and their positions in high growth sectors. Confidence to invest has remained high due to the relatively strong economic performance of the United States where growth has already returned to its pre-pandemic trend whereas in the eurozone, UK and Canada it has not. The maths behind this is based on extrapolating the growth rate of the five years up until COVID until the end of 2023 and then comparing what has been achieved with that imaginary reference point. Put into a few words, in growth terms it's as if COVID never happened in the US as the actual position is the same as the extrapolated point. As of December 2023, Canada's real GDP is about 4 percentage points below where it would have been if COVID had not happened, the euro area is around 5 percentage points below and the United Kingdom around 6 percentage points under. A further difference between the United States and the others is that the U.S. is alone in resuming its pre-pandemic growth trend.

A combination of factors contributes to this divergent performance and US government borrowings have increased at a faster rate than those of the other countries, US individuals and companies have been more insulated from interest rate rises due to a higher propensity to borrow at fixed rates, the US has a more flexible workforce which during COVID translated into a high unemployment rate but then far more sectoral reallocation and the number of companies that have been formed versus those that have gone bankrupt is far greater in the United States than on this side of the Atlantic. Finally, it seems that targeted post-pandemic government spending such as the Inflation Reduction Act and also the CHIPS and Science Act seem to have been effective at stimulating certain sectors of the economy at a grass roots level.

This analysis touches on and validates the notion that good governments espouse policies that translate into economic growth and in this year of elections its worth spending a moment focusing on Venezuela whose President, Nicolás Maduro, was, to nobody's surprise other than the majority who appear to have voted for the opposition, re-elected on 28th July, a date he chose carefully, being the birthday of his predecessor and mentor, Hugo Chávez. This is a country that, almost unbelievably, has the world's largest proven oil reserves – almost 17% of the global total, has fertile land in abundance and pristine Caribbean coastline. Despite these positives, GDP has fallen by around 80% over the last ten years and it is estimated that seven million of its people have left the country out of desperation. In 2022 the so-called Misery Index, which is calculated by adding a country's inflation rate to its unemployment rate ranked Venezuela second, behind Zimbabwe but ahead of Syria and Lebanon. Its record of debt default is awful and has little credibility in international bond markets because of the lack of trust in the administration of the country despite its abundant assets. Its two year bond which matures on 15th September 2027 is currently yielding around 87%.

Politics does not seem to change in countries like Venezuela but it would appear that in countries like the United Kingdom the long term trend is one of change, certainly in style. It has become more aggressive, confrontational and tactical and the media has a greater influence on many of us than it used to, if for no other reason that it is more difficult to avoid and more competition within the media appears to have made it more aggressive, confrontational and tactical. This memorandum always aims to look past the politics of the world but with the uncertainty and change that this year's elections

promise, some reflection cannot be avoided. The burden of taxation is already very high in most G8 countries which have worsening demographics, perceived poor public services, infrastructure issues and are pushing up against limits of sensible debt management. Allied to the possibility that further hostility in the world, either real or in trade could trigger another wave of inflation and corresponding interest rate rises and it is Meridian's view that the risks around the bond market are higher than would be liked for the returns on offer. These last three years have presented bond investing in a very different light when compared with the previous forty years.

And so to equities. What is the measure of risk in equity markets? Can it be simply that the market presents as expensive compared to historic averages? Can it be that benign international cooperation is increasingly threatened by nationalistic politics? Can it be that investors have become beguiled by the gains that have been made and there is a fear of missing out? This memorandum finishes with similar comments to those in previous iterations. Two key metrics remain at the forefront of our thinking and investors should use them to anchor sentiment. World economic growth is estimated at around 3.2% in 2024, rising slightly to 3.3% in 2025. These estimates by the IMF have been revised upwards over the last year. Secondly, company earnings are, in the main, following a healthy trend. Referencing the second quarter U.S. reporting season which is almost halfway through at the time of writing, earnings growth (year on year) for the S&P 500 is 9.8% and the forward price/earnings ratio for the S&P500 is 20.6. This is above the five year average of 19.3 and the 10 year average of 17.9 but by relatively small amounts. If the market is right and it anticipates that earnings growth will continue, then the former helps justify the latter. With markets at this level and a few high profile mega-cap companies trading on optimistic multiples, setbacks in the market are almost inevitable and what look like abrupt falls in their share prices are, in fact, small adjustments to the strong gains made over the last few years. We continue to favour equities for those who can look beyond the uncertainties of the moment or the month and choose to absent our clients from debt markets.

It was evident from the general tone of the whole party, that they had come to regard insolvency as the normal state of mankind, and the payment of debts as a disease that occasionally broke out. ~ Little Dorrit

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