



**meridian**  
ASSET MANAGEMENT (C.I.) LIMITED

## INVESTMENT MEMORANDUM

Investors were caught off their guard by the result of the U.K.'s EU referendum, resulting in very sharp movements in the currencies and securities markets. Nevertheless, markets have calmed down to some extent and the results over the quarter have been satisfactory. Sterling based investors with geographically diversified portfolios have seen the benefit of spreading the risk. Bond yields fell sharply in the perceived flight to safety with vast areas of the bond market standing on negative yields - approximately US\$11.7 trillion at the end of June. Our table shows the dramatic decline in sterling, with the largest fall being one of 15.5% against the yen. In the commodity markets, oil continued its recovery, although still standing at very depressed levels.

The tables below detail relevant movements in markets :

### International Equities 31.03.16 - 30.06.16

<b>Total Return Performances ( % )</b>				
<b>Country</b>	<b>Local Currency</b>	<b>£</b>	<b>US\$</b>	<b>€</b>
Australia	+3.9	+8.2	+0.6	+3.2
Finland	+1.5	+6.4	-1.0	+1.5
France	-0.9	+3.9	-3.3	-0.9
Germany	-2.3	+2.4	-4.8	-2.3
Hong Kong, China	+0.6	+8.1	+0.6	+3.2
Italy	-7.5	-3.1	-9.8	-7.5
Japan	-7.7	+8.8	+1.2	+3.8
Netherlands	-2.0	+2.8	-4.4	-2.0
Spain	-4.0	+0.6	-6.4	-4.0
Switzerland	+4.1	+10.0	+2.3	+4.9
UK	+6.2	+6.2	-1.2	+1.3
USA	+2.6	+10.3	+2.6	+5.2
Europe ex UK	-0.6	+4.2	-3.1	-0.6
All World Asia Pacific ex Japan	+1.5	+9.4	+0.8	+3.6
All World Asia Pacific	-3.3	+9.6	+1.0	+3.8
All World Latin America	+2.5	+10.5	+5.6	+8.3
All World All Emerging	+1.9	+9.5	+1.9	+4.5
All World	+1.3	+9.7	+1.1	+4.0

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +6.8%

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

Currency	31.03.16	30.06.16
Sterling	1.54	1.00
US Dollar	1.81	1.46
Yen	-0.05	-0.23
Germany (Euro)	0.15	-0.13

## Sterling's performance during the quarter ending 30.06.16 (%)

Currency	Quarter Ending 30.06.16
US Dollar	-7.8
Canadian Dollar	-7.8
Yen	-15.5
Euro	-5.3
Swiss Franc	-6.1
Australian Dollar	-5.1

## Other currency movements during the quarter ending 30.06.16 (%)

Currency	Quarter Ending 30.06.16
US Dollar / Canadian Dollar	N/C
US Dollar / Yen	-8.3
US Dollar / Euro	+2.7
Swiss Franc / Euro	+0.8
Euro / Yen	-10.8

## Significant Commodities (US dollar terms) 31.03.16 - 30.06.16 (%)

Currency	Quarter Ending 30.06.16
Oil	+24.2
Gold	+6.8

## MARKETS

For sterling based investors, this has been a remarkable quarter and the last week of the quarter has been the most remarkable of all post the Brexit vote. Following the initial reaction to the vote, markets staged a strong recovery with markets in local currency terms modestly better overall over the quarter and substantially so in sterling terms for investors with well diversified portfolios geographically.

Looking at local currency returns, firstly, there was a modest but satisfactory return from the FTSE All World Index in local currency terms of 1.3%. Within that, the strongest return came from the UK where the FTSE UK Index returned 6.2%. Within the European market, Switzerland rebounded strongly with the FTSE Switzerland returning 4.1%. The FTSE Australia Index also had an above average return at 3.9% and the USA was slightly above average with the FTSE USA Index returning 2.6%. On the negative side, Japan was weak with the FTSE Japan Index returning -7.7%. But, when we come to look at sterling returns, the picture changes dramatically following the marked fall in sterling after the referendum result became known. Perhaps most dramatic of all was the effect of a very strong yen which turned a poor local currency equity market result, described above, into only a slightly below average return from the FTSE Japan Index of 8.8%, which compares with the sterling adjusted FTSE All World Index return of 9.7%. Elsewhere, above average sterling adjusted returns came from the FTSE USA Index (10.3%), Latin America, where the FTSE All World Latin American Index returned 10.5%, and Switzerland, where the FTSE Switzerland index returned 10.0%. Although still a good performance, the FTSE UK Index returned a below average 6.2% and the FTSE Europe ex UK Index 4.2%.

The fallout from the Brexit vote drove down bond yields further although it may seem counter intuitive that equities, after the initial fall, rose strongly after the result. Taking 10 year government bonds as the benchmark, the gross redemption yield on the UK government bond fell by 54 basis points to 1.00%, on the US Treasury bond by 35 basis points to 1.46%, on the Japanese government bond by 18 basis points to -0.23% and on the German Bund by 28 basis points to -0.13%.

Movements in the foreign exchange market were dramatic following the EU referendum result. Sterling's largest fall over the quarter was by 15.5% against the yen, by 7.8% against the US dollar and Canadian dollar, by 6.1% against the Swiss Franc, by 5.3% against the euro and by 5.1% against the Australian dollar.

In the commodity markets, oil, as measured by Brent crude, recovered by 24.2% whilst gold, benefiting from increased uncertainty, rose by 6.8%, perhaps not as dramatic an increase as we might have expected.

## ECONOMICS

There are plenty of important economic and political events happening in the world but there is really only one major issue to concentrate on this quarter, the result of the UK referendum on the EU and the electorate's decision to vote "leave". Although a medium sized economy, the ramifications of the result are enormous. As this is written, only a few days after the vote, it is important to let the dust settle and precipitate decisions should not be made. What we will attempt to do in this review is to set out some preliminary thoughts around which investors should consider their investment policies. As ours is a discretionary investment management service, these are the thoughts which will be occupying our minds.

Before we set out our thinking, we should comment on the significant volatility in markets following the result, perhaps particularly as they affected sterling. One of the extraordinary facts which was clear on polling day and, therefore, well before the polling stations had closed, was the disconnect between movements in the stock market and sterling, on the one hand, and the opinion polls on the other. An average of the last opinion polls suggested a result which was too close to call, yet sterling, UK equities and the bookmaking odds all suggested an overwhelming conviction that “remain” would win. Although the record of opinion polls has recently been chequered, it was not a reason for ignoring them, especially when two of them showed “leave” ahead. This disconnect might have been the result of “group think” and the comfort to be drawn from thinking that one’s view was shared by many others and must therefore be right and reflected in the referendum result. It might also have been because London, being the main financial centre and quite strongly for “remain”, led people to thinking that its views were the views of the majority of the nation. Whatever the reason, as sterling headed towards US\$1.50 to the pound after the polls closed, but before the first results were announced, investors had little doubt as to the outcome, so, when the first results were announced and it was clear that the possibility of a “leave” result existed, it was little surprise that there was a violent reaction in sterling and a lesser one in the UK equity market. So, it is probably relevant to say that some of the extreme movements shown, particularly in the currency markets, are a result of speculative long positions in sterling being unwound, no doubt with some heavy losses being suffered.

Only time will tell whether the electorate has made the right decision and it will probably take many years to find out. What we can say is that markets do not like uncertainty and there will be plenty of that over the next few years. But there are certain basic rules which investors should follow in order to protect their portfolios and give themselves the opportunity to make positive returns. Coming back to the speculators who drove up the value of sterling in the days up to, and including, referendum day, they took risks which the opinion polls suggested they were unwise to do. Relating this to an equivalent equity market position, it would be that investors had put, say, half a portfolio into UK equities as a speculation that they would go up on a “remain” result, when UK equities represent less than 7% of the world’s market capitalisation, and then suffering badly when the UK equity market fell on a “leave” result although it has recovered strongly since the result was announced.

This, therefore, leads to one of the most important investment policies, which is to spread the risk, and what has happened since the referendum result emphasises this. A well spread portfolio by geography should reduce the risks caused by overconcentration in one area, as shown by the above example. Sterling based investors who had a well diversified portfolio geographically probably saw the sterling value of their portfolio enhanced after the vote as the fall in international share prices was more than offset by the benefits of the currency movements, assuming they were unhedged. Of course, one could argue that if “remain” had won, the pound may have risen further but one would still have been taking quite a speculative position given the message of the split opinion polls. So, in the aftermath of the referendum, observing one of the cardinal investment rules, spreading the risk, would have provided worthwhile insurance. Allied to this is that, when a potential risk event like the EU referendum occurs, it is important to be in high quality marketable securities because if the result is unexpected, liquidity can dry up. In these difficult political and economic times, even without the referendum, it is sensible to have high quality marketable securities in one’s portfolio. As an aside to this, some large open ended UK property funds have had to suspend dealings as their liquidity buffers had been exhausted by redemptions and the property assets, other than shares they held, were illiquid.

This spreading of the risk is also relevant to bond markets where, in the aftermath of the referendum result, high quality bond yields fell and currency gains for sterling investors with a diversified currency bond portfolio would have been seen which would have added to the capital appreciation. As clients will know, we find it very difficult to see any value in bonds and plenty of risks, given either negative or very low yields, but, in the immediate aftermath of an unexpected event like this, they seemed a safe place. For those taking a more realistic view of the outcome of the referendum,

based on the mixed messages coming from the opinion polls, holding some foreign currency cash deposits would have been another short term option.

So, whether it is a geographically diversified portfolio of equities, bonds or currencies, the benefits of prudent diversification especially in front of an event with the potential to move markets, particularly currencies, have been much in evidence in recent days.

In the immediate aftermath of the Brexit vote, many people are saying many different things and no one can say with any degree of certainty what is likely to happen in the months ahead. What we do know is that the UK is about to have a new Prime Minister, after which Article 50, giving notice of the UK's intention to withdraw from the EU, will be triggered, although we do not know exactly when the UK will give notice. For two years after notice is given, the UK will remain in the EU and there will be intense negotiations about the future relationship between the UK and the EU, on the one hand, and between the UK and other countries, on the other hand, with respect to bilateral trade deals. Again, nobody knows how these discussions will proceed.

What we can do to try to inform our investment policy is to look at possible outcomes for the UK and EU. Whilst most attention is focused on the UK, the implications for the EU could be even more profound, although, at present, that is taking second place to investors' concerns about the UK. We can exemplify the UK at present as a country which has been performing relatively well economically with above average economic growth amongst the developed economies, relatively low unemployment but with two troublesome deficits, namely the budget and current account ones. The assumption is that sterling will trade lower as a result of Brexit, the thinking (valid or otherwise) being that the economy would be more vulnerable outside the EU. This is different from the immediate post Brexit fall in sterling occasioned, in part, because of long speculative positions built up in sterling prior to the vote. Is it correct to assume that sterling will continue to trade at a lower level with a "leave" vote compared with what would have happened with a "remain" vote? The answer is probably "yes" in the short term. Assuming that sterling does not bounce back in the near future, the "J curve" effects on the trade account are likely to come into effect. The immediate effect of a devaluation is that imports become more expensive and, depending upon what UK exporters do with their prices, exports become cheaper and more competitive to foreign buyers, but it will take some time for the latter to work through the system in terms of raising export volumes. The trade deficit is likely, initially, to increase, theoretically putting more pressure on sterling before it improves as exporters benefit from selling their more competitive products abroad. Invisible exports like tourism should benefit quite soon as foreign holidaymakers find the UK more attractive, whilst UK holidaymakers might find home more attractive because of the increased costs of travelling abroad. However, manufacturing accounts for only about 11% of GDP so it has limited possibilities of contributing to an improved trade account, part of the current account. The UK has a dangerously large current account deficit standing at about 6.9% of GDP in the first quarter of 2016. This deficit has to be financed by running down overseas assets or attracting capital flows to the UK. This is where confidence comes in. Post the referendum vote, the government must do everything it can to enhance the attraction of the UK as a country in which to invest. This is not going to be easy with so much uncertainty about, even though UK assets will be cheaper to foreign investors.

The other deficit, the budget deficit, although it has been coming down as a percentage of GDP, is still too large at around 5% of GDP. At the moment, governments all over the world with large budget deficits are gaining some respite from the problem because servicing costs are being restrained by very low interest rates. This will not go on indefinitely and, if budget deficits are not controlled, debt servicing costs will cause very severe economic problems later on. High debt levels bear down on growth as higher percentages of government expenditure have to be devoted to debt servicing costs. The creditworthiness of countries then becomes an issue affecting credit ratings and the terms on which governments can borrow. In this respect, countries like the UK and Japan (with a far greater debt burden) have the benefit of controlling their own currencies and, therefore, can print money to pay off and service their debts, albeit exposing their currencies to enormous risk. Within a currency

union, individual countries' central banks cannot do this and one can end up with a Greek style situation where bail outs are required as the currency adjustment mechanism does not exist. Whilst the UK is in the fortunate position, despite the S & P downgrade to AA and on negative watch, of having a relatively strong credit rating and being able to borrow at extraordinarily low levels of interest rates, it cannot count on this position lasting indefinitely. However, being outside the eurozone does give the UK important advantages and one is the ability to allow an economy's "automatic stabilisers" to work. If the UK experiences a slowdown as a result of the post referendum uncertainty, then the "automatic stabilisers" can be allowed to work. When an economy is in recession or in a period of very slow growth, taxation revenues are adversely affected and government expenditure, say on social security, will increase. These are the "automatic stabilisers" insofar as they lead to an increased budget deficit which the government does not try to offset and this counters the contractionary threat to an economy caused by weak economic conditions. However, during the referendum campaign, the Chancellor threatened a tough budget in the event of Brexit. If this were to happen in the event of his being able to get it through parliament (unlikely), it would mean piling on pro cyclical forces, in other words, exacerbating the down cycle assuming that is the situation in which the UK finds itself. Whilst one can understand a Chancellor being concerned that the downward trajectory of the budget deficit was being threatened, many economists would have felt that such a measure would have been very unwise. With its own currency and very favourable borrowing terms, the UK is in a relatively good position to counter a post Brexit vote slowdown or recession. However, given the UK's budgetary position, such a stimulus caused by allowing the "automatic stabilisers" to work cannot go on indefinitely but seems justified in the immediate future. In fact, post the Brexit vote, the Chancellor has abandoned his balanced budget target for 2020.

Another feature which is helpful for the UK in this uncertain time is that the world is generally in an era of floating exchange rates, notwithstanding the fact that currency intervention is practised in some parts. The UK does not have to use precious foreign exchange reserves to support sterling as it might have done in the past under a fixed exchange rate regime, so the idea of going to the IMF for a loan to replenish foreign currency reserves no longer exists.

The UK should be able to forge individual trade deals which will be helpful in the long term. Because the EU has to have unanimous agreement amongst its 28 members, they take a long time to happen, if at all. Whilst globalisation is under fierce criticism from some quarters and protectionism on the increase, free trade, whilst there are some losers, does increase consumer welfare overall. However, whilst this likely new found freedom, plus less red EU tape, offers medium and long term prizes, over the shorter term, uncertainty is bound to affect economic activity in the UK as businesses and consumers hold off decisions which can be postponed. For this reason, monetary and fiscal policy must be accommodating, hence our reference to allowing the "automatic stabilisers" to work.

Whilst, quite naturally, much of the post referendum speculation has concerned the possible consequences for the UK, it is equally important to consider those for the EU and herein lies some hope, although not necessarily the expectation, that both sides will reach as pragmatic an agreement as possible. The EU with its aim of "ever closer union" is an intensely political project and this, unfortunately, may mean that economic considerations take second place. For Brexit may have even more implications for the EU which, if not handled with care, could cause further problems for the EU. In the political sense, the UK vote means that the independence genie is out of the bottle and we are already seeing demands for referendums elsewhere on a variety of issues. With the unthinkable now having happened and discontent with the EU rising, EU politicians will be very nervous. There may be particular issues for those in the eurozone. We have pointed out in these reviews many times that the eurozone is not an optimal currency area and its malign effects have been felt in southern Europe particularly with appalling levels of unemployment, particularly at the youth level. We talked earlier about the benefits for the UK of having the shock absorber of a floating exchange rate. That obviously cannot happen in the eurozone. So, if the UK's decision to leave the EU creates doubt about the future of the eurozone and the wider EU, this could have significant confidence effects on the euro. Of less immediate effect, but important in the long term, is that it changes the balance between the

more liberal economic countries, for example Germany and the Netherlands to name but two, and the more protectionist bloc led by France. One would hope that both sides of the negotiations would understand the importance of maintaining liberal trade links. Often during the referendum campaign, the “leave” side referred to the enormous trade imbalance between the EU and the UK. EU exporters to the UK will surely not want the political fallout to lead to the UK market becoming less accessible to them and it can be expected that they will put pressure on their respective governments to try to avoid any punitive action towards the UK. That would be the rational action but politics may trump it. For the UK, on the wrong end of the trade imbalance, bilateral trade deals elsewhere could partly offset the problems of more difficult access to the EU markets, if that turns out to be the case, although one should not overstate this advantage in the short term because it is bound to be a long term benefit. Trade flows are unlikely to change dramatically in the short term. Looking at the situation rationally, one would hope that the EU, being in an area of relative economic decline, i.e. it is growing less faster than most other major areas and with a precarious situation in a number of the eurozone economies, will be as accommodating as possible if only because it has a vested interest in doing so. One realises, however, that the rest of the EU feels bruised by what has happened and may be in no mood to be accommodating towards the UK. If what has happened leads to doubts about future membership of the eurozone for a number of countries, the euro could be affected.

Given that we do not know how the programme of the UK’s withdrawal from the EU will work out in the coming years, what we do know, as we said earlier, is that there will be a period of uncertainty, so, how should investors position themselves in such an environment and what should governments and central banks do, if anything? If one is a sterling based investor, the merits of geographical diversification have already been discussed and validated by what has happened post the Brexit vote. For the UK equity allocations, if the post Brexit fall in sterling endures, the usual devaluation classic policy of holding overseas earners remains sound as exports become more competitive and the value of overseas earnings increases. If, as is probable, inflation increases as a result of the fall in the pound, then utilities, with their dividends often linked to inflation and their already relatively attractive yields, could continue to hold a place in portfolios. Larger UK companies, with their international spread of business and which are represented in the FTSE 100 Index, have appeal. In the short term, post referendum economic uncertainty is very likely to subdue economic activity in the UK and small and medium sized domestically orientated companies may underperform for a while and that was the post referendum experience. For the overseas equity position of a portfolio, unless the companies have a particularly large exposure to the UK and may therefore be adversely affected by a temporary slowdown in the UK economy, there is little reason to change existing stock selections in response to Brexit.

In relation to the official economic response to the economic situation created by the referendum result, we have discussed what the UK fiscal response might be, which is to let the “automatic stabilisers” work and run a larger than planned budget deficit. Having a tough budget to reinforce cyclical forces in the economy would be unwise. This might seem a surprising thing to say, given the size of the budget deficit, but these are exceptional times and the markets would probably understand this. As far as monetary policy is concerned, current very low interest rates mean that there is very little scope to stimulate the economy further. Interest rates could be cut slightly but such a move would be so marginal that it would be unlikely to stimulate any further activity. It is, however, likely to happen. With sterling still fragile, a move to negative interest rates could threaten a further fall in the exchange rate which would be undesirable given how far it has moved down. We remain very wary of the fixed interest market. The downgrading of the UK’s credit rating is not a major issue. It is still relatively very high and, like another country running a large budget deficit and with a much higher level of outstanding public debt to GDP, Japan, it has its own currency so will not default on its domestic debt. However, at one stage, the ten year UK gilt yield fell below 1% and, in our view, this does not look an appealing investment compared with certain equities, say either UK companies with large overseas exposure or overseas equities themselves. It is pertinent to observe that the dividend yields on most equity markets are higher than the yields on their respective countries’ 10 year bonds and, whilst one must be cautious about the prospects for dividend growth in view of the various forecasts



for downgraded growth, meaningful falls are very unlikely. Unless the world economy undergoes a period of deflation, which we think unlikely, we can be fairly sure that, at some stage, bond yields are going to rise significantly and, therefore, prices fall and that, over time, equities will continue to rise, albeit in an uneven way. One can understand why bond yields are so low but it is increasingly difficult to see why so many are on negative yields. Are things so bad in the world economy that investors are prepared to invest with certain knowledge that, if held to redemption, there will be a loss? We do not think so. Massive ECB and Bank of Japan buying has helped to cause this situation but it does not make them attractive investments for those who do not have to hold fixed interest securities.

Whilst the latest quarter has generally seen positive returns from portfolios, the effect of the weakness of sterling on overseas assets has been apparent and should certainly not lead to any complacency by investors. Where it has been possible to invest overseas, the diversification benefits have shown through strongly. The level of returns in this latest quarter is unlikely to be repeated and more modest and uneven rises are likely. The world economy will continue to grow, albeit modestly, and companies with a geographical spread of business to take advantage of this are best placed to benefit from this focus. Many of the large multi nationals have performed well and are, accordingly, highly rated but with interest rates relatively low or negative, these companies' yield advantages, in a yield starved investment world, are attractive. Whilst returns so far this year have exceeded our expectations for sterling investors because of sterling's depreciation and this was something which had not been built into expectations at the beginning of 2016, equities seem the asset class best placed to withstand current uncertainties. It will, in our view, be an uneven movement upwards.

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