meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equities have continued to make progress during the quarter in contrast to bonds which have weakened as earlier optimism about the timing and trajectory of interest rate reductions faded. In the currency markets sterling has generally strengthened except against the Australian dollar in our table. Gold has enjoyed a strong quarter with the suspicion that central bank purchases have been behind the rise.

The tables below detail relevant movements in markets :

International Equities 29.02.24 - 31.05.24

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+0.9	+2.4	+3.0	+2.7
Finland	+8.4	+8.0	+8.8	+8.4
France	+3.5	+3.2	+3.9	+3.5
Germany	+4.6	+4.3	+5.0	+4.6
Hong Kong	+2.2	+1.6	+2.2	+1.9
Italy	+9.6	+9.3	+10.0	+9.6
Japan	+4.6	-1.0	-0.4	-0.7
Netherlands	+4.8	+4.4	+5.1	+4.8
Spain	+15.9	+15.5	+16.2	+15.9
Switzerland	+7.7	+4.5	+5.1	+4.8
UK	+9.4	+9.4	+10.1	+9.7
USA	+3.6	+2.9	+3.6	+3.3
All World Europe ex UK	+6.7	+5.7	+6.4	+6.1
All World Asia Pacific ex Japan	+5.8	+4.4	+5.1	+4.7
All World Asia Pacific	+5.4	+2.4	+3.1	+2.8
All World Latin America	-2.8	-6.3	-5.7	-6.0
All World All Emerging Markets	+5.7	+4.0	+4.6	+4.3
All World	+4.3	+3.2	+3.9	+3.6

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -0.4%

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

Currency	29.02.24	31.05.24
Sterling	4.12	4.32
US Dollar	4.25	4.50
Yen	0.70	1.06
Germany (Euro)	2.41	2.66

Sterling's performance during the quarter ending 31.05.24 (%)

Currency	Quarter Ending 31.05.24
US Dollar	+0.9
Canadian Dollar	+1.3
Yen	+5.7
Euro	+0.5
Swiss Franc	+3.0
Australian Dollar	-1.4

Other currency movements during the quarter ending 31.05.24 (%)

Currency	Quarter Ending 31.05.24
US Dollar / Canadian Dollar	+0.4
US Dollar / Yen	+4.9
US Dollar / Euro	-0.4
Swiss Franc / Euro	-2.5
Euro / Yen	+5.3

Significant Commodities (US dollar terms) 24.02.24 - 31.05.24 (%)

Currency	Quarter Ending 31.05.24
Oil	-2.1
Gold	+15.6

MARKETS

It has been a quarter of contrasting fortunes. Equities moved modestly higher whilst bonds retreated as optimism about lower interest rates was tempered by some disappointment about the path of inflation.

In the international equity markets, the FTSE All World Index returned +4.3% in local currency terms, +3.2% in sterling terms, +3.9% in US dollar terms and +3.6% in euro terms. Looking at local currency returns firstly, there were above average returns from the FTSE UK Index, +9.4%, the FTSE All World Europe ex UK Index, +6.7%, the FTSE All World Asia Pacific ex Japan Index, +5.8% and the FTSE World Emerging Markets Index, +5.7%. On the other hand, there were below average performances from the FTSE All World Latin America Index, -2.8%, and the FTSE Australia Index, +0.9%. Moving on to sterling adjusted returns, the outperformance of the FTSE UK Index is relatively stronger. The FTSE All World Europe ex UK Index, +5.7%, maintained a relatively strong performance. An improvement in the Australian dollar meant that the FTSE Australia Index, +2.4%, underperformed by a smaller amount. On the other hand, weakness in the yen turned a positive local currency performance from the FTSE Japan Index into a negative one, -1.0%. Weakness in the Latin American currencies left the sterling adjusted FTSE All World Latin America Index at -6.3% for the quarter.

However, it was not such a good story in the international bond markets. Taking benchmark ten year government bonds, the gross redemption yield on the UK gilt rose by 20 basis points to 4.32%, on the US Treasury bond by 25 basis points to 4.50%, on the Japanese Government Bond by 36 basis points to 1.06% and, on the German Bund, by 25 basis points to 2.66%.

In the currency markets, sterling was generally stronger, except against the Australian dollar against which it fell by 1.4%. On the other hand, it rose by 5.7% against the yen, by 3.0% against the Swiss Franc, by 1.3% against the Canadian dollar, by 0.9% against the US dollar and by 0.5% against the euro.

In the commodity markets, oil, as measured by Brent crude, fell by 2.1%, but gold was exceptionally strong, +15.6%, as a result, partly, of central bank buying, including by China.

ECONOMICS

If literature is a question minus the answer then Meridian's monthly memorandum is something quite apart.

When writing this piece each month there is a natural inclination to attempt to answer unknown questions from an imaginary audience when all that is known is that it is, most likely, a client, or hopefully more than one client, of Meridian who seeks to gauge our views. At any time, the subject matter could be considered limitless and, furthermore, the study of global economics feels barely a science given the contradictions in its application. At this stage, it establishes that the topic for consideration is infinitely complex and the request for information is elusive but this month, amongst other things, there is a reflection on another immeasurable, the element of surprise.

Stock markets often surprise and they surprise in different ways. A sudden unexpected piece of news can lead to a rapid sell off, with the example that is still fresh in our minds, despite being over four years ago, being the COVID impact of March 2020. No surprise there, but the speed of the recovery certainly was. Those who sold out as the market fell around 25% in 25 days would have felt bruised by the market recovery, those who bought in at a low point would have had an exceptional year and those that remained fully invested throughout weathered the storm with some success as the market ended up around 13% over the calendar year. Perhaps a different kind of surprise is when markets remain high for a long period, against the perception of many. To many of those people such circumstances might currently apply and the starting point is the consideration that either the markets are wrong or the perception is wrong. Perhaps it's more nuanced that that.

Investing is a subject of choice and at any time and, like any other choice, the upside must be balanced with the downside. The risk to capital and the income it generates must be considered, with the long term considerations being the correct measure and yet we hear so much of economies laden with debt and flirting with recession as consumers face a high inflation cost of living crisis. How can it be that markets are at, or near, all-time highs? The US equity market, the FTSE 100, the Japanese NIKKEI equity index, gold and bitcoin, to name just a few, are at around record highs despite the highest interest rates for a decade and a half and the politics of the world suggesting a phase of history where cooperation and mutual regard between countries is not felt in the same way it was in the latter decades of the 20th century; the years following the fall of the Berlin Wall may prove to be a high water mark of internationalism.

The International Monetary Fund is fully vested in the direction of travel of the global economy and is, perhaps, best known for providing emergency funding to struggling countries. In some ways it works like an insurance company with 190 member countries all contributing reserves with, at the present time, the three countries most indebted to the IMF being Argentina ($24.6 billion), Egypt ($8.5 billion) and Ukraine ($6.8 billion). During COVID, the fund provided emergency funding to 86 countries and before that, for example, supported Greece, Ireland, Portugal and Cyprus during the eurozone crisis. Being as close as it is to its member countries' economies it is well placed to measure and forecast and as we have said in previous memoranda economic news tends to be viewed as better or worse rather than good or bad. Points of inflection are sought out and changes in the rate of improvement celebrated and the opposite regretted. It has modestly upgraded its outlook for global growth (3.2% for 2024 and 2025) as the world appears to have dodged a global recession and a period of stagflation – the most unwelcome combination of low economic growth and high inflation. They do estimate, however, that the global output loss since 2020, by which they mean the growth that has been missed due to the effects of COVID is around $3.3 trillion with lower income countries suffering disproportionately. The US has experienced the strongest rebound with resilient consumer spending and rising productivity growth with certain emerging markets also enjoying improved levels of activity. Inflation, the great disruptor, is also settling down at acceptable levels after a short but painful bout. The IMF points to "sound macroeconomic fundamentals built over the last years" as being the bedrock for the resilience we are enjoying and highlights strong and mobile labour forces. The counterweight to this optimism is that most governments find themselves in a position where debt is more of a burden than it has been in living memory. The Great Financial Crisis and COVID created two incremental steps up in debt levels and the burst of inflation since COVID has driven up interest rates in most countries. In advanced economies, excluding the US, interest payments on public debt will consume around 5% of the public purse whilst in low income countries, the IMF warns, their interest payments will average around 14% of government revenue, roughly double what it was 15 years ago. This at a time when competing calls on government spending are as numerous as they have ever been. The highest priority economic goal remains beating price instability and in almost all cases this has meant raising interest rates, which, naturally, contributes to the cost of servicing debt. It will be interesting to see how many of the 60 or so countries holding general elections this year will change government.

The Congressional Budget Office (CBO) in United States acts in a similar way to the Office for Budget Responsibility in UK, acting as an independent overseer of government's actions and intentions and its output on the US budget illuminates the difficulty that developed countries face. The federal deficit in 2023 was 6.3% of Gross Domestic Product, which compares with an average deficit over the past 50 years of 3.7%, and in money terms government expenditure exceeded tax receipts by $1.7 trillion. The difficulty faced in managing down this spending issue becomes apparent on closer inspection of how the US government spends. Total tax take was $4.4 trillion with total outlays of $6.1 trillion. Within the spending, $3.8 trillion is titled 'mandatory' and covers social security payments, pensions, healthcare commitments and similar. The next tranche is called 'discretionary'' and covers 'Defense' spending of $805 billion and 'Nondefense' of $917 billion. 'Nondefense' covers a wide range of spending such as veterans' healthcare, education and transportation and would include, for example, the recent Bipartisan Infrastructure Law which will channel $1.2 trillion into state and local capital investment. Finally, there are net debt interest payments of $659 billion which can be thought of as being mandatory. When broken down in this way it becomes apparent that there is no easy fix to this over-spend and the best solution would be to grow the economy in real terms so that tax take grows at a faster rate than spending. The temptation, elections permitting, is to raise taxation though there are risks that follow the obvious benefits of doing this. Standard & Poor's, the credit rating agency, estimates that nations will borrow $11.5 trillion in long term debt in 2024. There are consequences to being this much in debt and governments' ability to implement effective policy is hampered by the costs of being in this position.

Going back to IMF figures, average government debt is expected to reach 120% of GDP by 2028. Only a few years back economists would have warned over the consequences of debt above 90% of GDP. Indeed, two notable Harvard economists, Reinhart and Roggoff, argued in an influential 2010 paper that GDP growth slows to a snail's pace once government debt levels exceed 90% of GDP but other academics questioned their methodology and assumptions and the debate on the relationship between indebtedness and growth appears inconclusive; doubtless countries' growth patterns will inform the debate as reality replaces theory. There was a level of concern following the publication of Reinhart and Rogoff's "Growth in a Time of Debt" study as it was suggested that its influence was felt in both political debate and, in particular, US government policy through a budget proposal where sensitivities around high levels of debt leant policy towards austerity. The fear of the consequences of such indebtedness is said to have influenced UK policy when George Osborne became Chancellor of the Exchequer to the point that the scholars became known as the 'godfathers of austerity'. The Americans did subsequently admit to an error in their computations but maintained high debt stops growth. The burden of debt on a country's economy is one thing and the effect it will have on bond investing remains unknown.

Bond markets narrowly escaped a third consecutive year of decline in 2023 – something that would have been the first occasion on record as the rise of interest rates from historic lows, at an historic rate of increase, had its effect on the value of fixed interest assets. Prices had to fall for yields on those lower prices to rise to reflect the new normal. So far in 2024 bond prices, and hence returns, have fluctuated as uncertainties continue to cloud the outlook. Reference to the first pages of this memorandum show that the gross redemption yield which, in effect, is the total return to the holder of buying a 10 year gilt and holding it to maturity is 4.32%. By adding credit risk and buying a 10 year high grade corporate bond it's possible to improve the return in absolute terms. By lending the money to pharmaceutical giant GSK Plc, the bond holder will receive a gross redemption yield of 4.86% if the 'A' rated bond is held to maturity, in December 2033.

As an asset class, the bond market has moved the furthest in the face of the changing interest rate environment and that partially reflects how displaced it was in 2021 or perhaps a better word than displaced is overvalued. Value is always subjective but when high quality companies can borrow money for less than free in real terms then the return on being the lender must surely be considered poor value. Bond markets have become more rational but remain vulnerable to sticky inflation and higher interest rates. That vulnerability goes hand in hand with bond investing but the decades-long fall in interest rates has largely hidden that vulnerability from view which has had an effect on perceptions of returns. Another key aspect of the bond market that informs our view relates to the supply of new bonds to the market and we remain of the opinion that the returns available at the current time are not attractive enough given the dynamics of the market. Credit rating agency Standard & Poor's estimates that war, energy subsidies, welfare spending and high interest rates will cause almost all countries to extend their borrowings as tax income fails to match government expenditure. In numerical terms their estimate is $11.5 trillion will be borrowed this year which is almost as much as the $11.6 trillion borrowed in 2021 as the world responded to the COVID pandemic. As supply of a good increases its price is likely to fall and given bond investing is, for a large part of the market, a choice, price may have to fall significantly to attract enough buyers. Anticipation of future supply must also inform investors' thinking and it doesn't look like governments are going to be able to manage down their primary deficits any time soon as the example above of the United States shows. It would be amiss to not mention Rishi Sunak's announcement of a General Election on 4th July as next time this memorandum is circulated the result will be known. A surprise announcement? Many appeared to be caught out. Politics is outside of the ambit of this memorandum but the consequences of politics must be considered. No matter which party or parties form the next government there will be little room for manoeuvre. Where we see a new government, the new administration usually wastes little time in getting the bad news out as it can be pinned on the 'mess we inherited from the last lot'. There is not too much doubt that taxation will have to rise to address those stubborn deficits and raising taxes is always political because of the targeting of the increases and ideology can ride roughshod over what is best in pure economic terms. Speaking on behalf of the investor, it is a concern that jurisdictions can become less attractive end markets and, also, as domiciles for companies and this is an area where the UK has had success in the past. International trading businesses have historically been attracted to base themselves in the UK as a good place to do business and if it is the case that an anti-business sentiment develops in any country then it won't be long before that country learns how mobile those affected companies are. If all countries were to hypothetically increase the tax burden imposed on its resident companies then, logically, there would be no reason to suffer the upheaval of moving but doing business is complicated and nuanced and there will always be another country that seeks a competitive advantage. It follows that companies are run, as much as for anything else, for the benefit of their owners – shareholders, so shouldn't companies, within reason, be tax-efficient?

It is worth highlighting that, where mandated to do so, Meridian invests internationally and treats the United Kingdom as a market like any other. Furthermore the 'British' FTSE100 companies that Meridian tends to invest in are, in a similar way, international but with British domicile. It is hoped, but not certain, that any new administration would seek to encourage foreign investment and support companies that can create jobs and wealth in the country. At a time when the burden of personal taxation is already very high and yet the government is running a significant deficit, any government will be searching for ways to increase the tax take and companies may appear to offer some easy wins, especially as pre-election pledges that may appeal to taxpayers are being made. Unfortunately, political easy wins can mean economic losses and it is hoped that politicians will consider the effects, both initial and secondary, of making any far reaching decisions. Any changes made to portfolios caused by perceived incipient political risk are likely to be minor.

The unasked question is how do we justify remaining invested in the shares of the companies we do given all of the above? They have, indeed, become more expensive than they were if measured, for example, in terms of share price divided by profit per share. A strangely unsatisfactory answer to the question "why have you decided to get a dog?" is "because I don't like cats" but this offers a crude and partial explanation of the attractions of equity investing. Bonds are much more attractive than they have been but supply issues and uncertainty around the trajectories of inflation and interest rates detract greatly from their appeal. Meridian is not constrained in what asset classes it invests in, but long standing clients have been rewarded over many years by holding equities. The attraction of cash is that its attractions have never really changed; the risk to capital can be effectively zero but the return over time will be around the rate of inflation, so, no growth in real terms but no loss either.

More constructively, over time the companies we invest in have shown an ability to grow their earnings at a greater rate than the economy has grown, sometimes significantly so. They tend to have common characteristics that lead them to achieve that. Successful strategy derives from good management and employing the best people. The building of moats – aspects of the business that make it difficult for competitors to catch up, such as branding, intellectual property and economies of scale are a key part of the model and referring to the last of those, most of the companies held are dominant players in their markets and have a global or near global reach but retain an ability to adapt and drive change. The quarterly U.S. reporting season of company results is, more or less, finished with 97% of companies by market capitalisation having reported at the time of writing. Earnings per share are up 5.9%, when compared with the same quarter a year earlier on revenue growth of around 4.3%, according to Bloomberg analysis. These are solid figures and lend credence to the belief that whilst the world news is dismal, the consumer is still spending and costs are being managed. Again, markets are less a barometer of the turmoil in the world and more a measure of success of businesses in growing, not that these two are mutually exclusive.

Looking at this global picture, if the world economy grows at an inflation-adjusted 3.2%, the IMF's current estimate for this year, then it's roughly equivalent to adding an economy the size of United Kingdom's to the world economy. We have grown accustomed to companies meeting and creating demand successfully through a range of market conditions and straight line growth is too much to expect but inflation-adjusted income growth over the medium term translates into medium term real growth in the value of the company's stock.

There should be no surprise to anything that has been written here. Uncertainty in equity investing is the known known and clients are amply forewarned about that. The act of remaining in the market gives periodic reminders of its unpredictable nature and those who have not experienced a sudden drop in value in their portfolios should be comforted that it is one in an ongoing erratic series of such episodes. If it can be summarised briefly, then, the equity market enjoy long periods of gentle upward progress punctuated by abrupt falls, which, overall, are far less significant. The market is expensive, but companies continue to innovate and evolve and we should not be surprised by their ability to grow in almost all market conditions. It would be a surprise if we did not suffer negative quarters, but we continue to believe that markets will generate satisfactory medium to long term real returns for our investors.

A.I. and diabetes/weight loss drugs are two of the most eye-catching developments of the past twelve months and demonstrate how value can be created. These are two very different developments and are both of global significance and, whilst both remain novel, the initial benefit is to the holders of the stock in that exclusive group of companies at the vanguard of development. The wider economic benefit will be felt as AI is employed in more and more business areas and the more effective treatment of diabetes and issues around weight improve the health of millions of people. Beyond that, there is the effect on confidence that is generated by such innovation and this has a very supportive effect on markets.

So much happens in a month and yet so much remains unchanged. Markets continue to speculate on the timing and extent of interest rate cuts, levels imply only limited concern about the conflicts of the world and the change (for the worse) in international relations is something that should exercise our minds but everyone has a vested interest in continuing to trade internationally. That position cannot be understated. The threat of another large event remains, with Taiwan seeming to be top of the list and the US and China polish their weapons and stare each other down. Both are sensible enough to see the downside of war – real and economic, but China sees Taiwan as a natural part of its territories. Can it be that markets are choosing to discount the negatives here – Taiwan, Gaza and Ukraine and credit the positives – AI and Ozempic? The primary appeal of the equity market continues to be its confidence in companies' ability to grow profits and simultaneously see past the background noise of politics, elections and wars. Perhaps the surprise we should most fear is if companies' profits growth ceases but there is no evidence of that eventuality at present.