meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Although this has been a very eventful quarter, notably in the USA, international equity markets have not moved significantly over the quarter, although Wall Street has been pushing new highs. Bond markets, not unexpectedly, have suffered a very poor quarter as they were always vulnerable given their severely overbought position. In the currency markets, the yen was notably weak and the US dollar very strong. Gold has experienced a poor quarter.

The tables below detail relevant movements in markets :

International Equities 31.08.16 - 30.11.16

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+2.3	+5.5	+0.6	+5.6
Finland	-1.3	-1.5	-6.0	-1.3
France	+3.9	+3.7	-1.1	+3.9
Germany	-0.1	-0.3	-4.9	-0.1
Hong Kong, China	+1.0	+5.9	+1.0	+6.0
Italy	-0.2	-0.4	-5.0	-0.2
Japan	+11.2	+5.8	+0.9	+6.0
Netherlands	-1.0	-1.2	-5.7	-1.0
Spain	+0.4	+0.2	-4.4	+0.4
Switzerland	-3.6	-2.5	-7.0	-2.4
UK	+0.7	+0.7	-4.0	+0.8
USA	+1.9	+6.8	+1.9	+6.9
Europe ex UK	-0.3	-0.4	-5.0	-0.3
All World Asia Pacific ex Japan	-0.1	+2.7	-2.0	+2.9
All World Asia Pacific	+4.5	+4.0	-0.8	+4.2
All World Latin America	+2.5	+2.3	-2.4	+2.4
All World All Emerging Markets	-0.7	+2.2	-2.5	+2.4
All World	+2.0	+4.6	-0.2	+4.8

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : -7.3%

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

Currency	31.08.16	30.11.16
Sterling	0.64	1.42
US Dollar	1.57	2.39
Yen	-0.06	0.02
Germany (Euro)	-0.13	0.20

Sterling's performance during the quarter ending 30.11.16 (%)

Currency	Quarter Ending 30.11.16
US Dollar	-4.9
Canadian Dollar	-2.8
Yen	+5.1
Euro	+0.1
Swiss Franc	-1.5
Australian Dollar	-3.2

Other currency movements during the quarter ending 30.11.16 (%)

Currency	Quarter Ending 30.11.16
US Dollar / Canadian Dollar	+2.2
US Dollar / Yen	+10.5
US Dollar / Euro	+5.3
Swiss Franc / Euro	+1.6
Euro / Yen	+5.0

Significant Commodities (US dollar terms) 31.08.16 - 30.11.16 (%)

Currency	Quarter Ending 30.11.16
Oil	+9.1
Gold	-10.0

MARKETS

It has been a stable quarter for international equity markets. In local currency terms, the FTSE All World Index returned 2.0%, in sterling terms 4.6%, in U.S. dollar terms -0.2% and, in euro terms, 4.8%. Looking at local currency returns first, the outstanding performer was Japan, where the FTSE Japan Index returned 11.2%. This helped the second strongest performer on our table, the FTSE Asia Pacific Index, which returned 6.2%. Other performances did not diverge significantly from the FTSE All World Index. In sterling terms, because of the weakness of the yen, the return on the FTSE Japan Index came down to a still good 5.8%. Because of the strength of the U.S. dollar, a slightly below average performance from the FTSE U.S.A. Index in local currency terms became an above average performance in sterling terms with the index returning 6.8%. Australia, too, showed up well in sterling terms with the FTSE Australia Index returning 5.5%. The disappointing performance came from Europe ex U.K. where the sterling return on the FTSE Europe ex U.K. Index was -0.4%.

International bond markets, reflecting, in our view, a severe overvaluation, endured a poor quarter. Taking ten year government bond yields as a benchmark, the gross redemption yield on the ten year U.K. gilt rose by 78 basis points to 1.42%, on the U.S. Treasury by 82 basis points to 2.39%, on the Japanese Government Bond by 8 basis points to 0.02% (the Bank of Japan's quantitative easing policy is targeting a zero yield on this bond) and on the German Bund by 33 basis points to 0.20%.

Currency markets were mixed. Sterling rose against a weak yen by 5.1% and marginally against the euro by 0.1% but fell 4.9% against the U.S. dollar, 3.2% against the Australian dollar, 2.8% against the Canadian dollar and 1.5% against the Swiss Franc.

In commodity markets, oil, as measured by Brent crude, rose by 9.1% but gold was disappointing, falling by 10.0%

ECONOMICS

It is hard to think of any single event in recent years that has prompted so much reflection on the trajectory the world and its people are on. Donald J. Trump will become the 45th President of the United States on 20th January 2017. He is, of course, a figure who strongly divides opinion as if seeking to do so, whose combative and antagonistic approach in nearly every situation has been evident in the 18 months it has taken him to move from presidential candidate to President-elect. There was some surprise as he moved past more experienced political operators to secure the Republican party nomination and yet more when he secured sufficient electoral college votes to clinch the most important job in the country. His anti-establishment stance shone through. His son's description of him as "a blue collar guy with a big balance sheet" chimed with middle America, at just the time when they felt nobody was listening to them. And at some time through his acceptance speech the stock market decided they, too, liked what had happened.

What do Bill Clinton, Ronald Reagan, Dwight D. Eisenhower, Jimmy Carter, George W. Bush, Franklin D. Roosevelt, Harry S. Truman and Barack Obama have in common? The Dow Jones Industrial Index fell the day after their election victories. More broadly, U.S. equities have risen only one in three times after the election of all Presidents since 1928. This time markets rose the day before the election following news over the weekend that the F.B.I. was not going to pursue an enquiry into

Hillary Clinton's use of a private e-mail server. This seemed to add to the argument for a Clinton victory and reinforced the sense that a 'more of the same' choice would be less jarring than the election to President of someone who has no experience of public office, the military or the diplomatic service. Yet, the market opened on 9th November higher and then rose.

The politics of Mr Trump may look very unconventional but, and it's very early to be certain, his economics look more solid. We will look at this in further detail below but a huge proposed infrastructure spend can only have a positive effect on the internal economy as steel producers, engineers, designers, planners and labourers all find greater demand for their services. It would follow that this injection of cash into the domestic economy would create inflationary pressures which, in turn, would lead to higher interest rates to keep demand for money in check. It may look like bare optimism but the new President is presented with an opportunity to re-establish a more positive diplomatic relationship with Russia, which, far more important than any economic good, could set the foundation for an improvement of the situation in Syria and the surrounding countries. Whether a 1,900 mile long wall will appear along the Mexican border remains to be seen.

At the time of writing this memorandum the US market has risen to new highs. It now seems that the social impact and the economic impact of the result are quite different themes and it now looks like the pre-election focus on the two by the press and commentators may have been unbalanced. The current thinking is that Trump will have good opportunity to drive forward some of the more pragmatic policies on his agenda whilst the Republican controlled Congress will successfully rein him in in those areas where he has been at his most controversial. Could it be that enough American voters saw beyond the rhetoric and bought the expansionary idea? The alternative argument is that it was a campaign which focused on a theme which is becoming prevalent in so many countries - a deep disaffection towards the established ruling elite. It remains to be seen whether any new alternative can be converted into better government. It was also notable that, during November, the Dow Jones Industrial Index, the S&P500, the NASDAQ and the Russell 2000 all ended at an all-time high on the same day; this was the first time this has happened since 31st December 1999. Two contributory factors have helped push the whole market to this level. Firstly, the feeling that the pro-market, expansionary policies will lead to a higher rate of economic growth, which will be reflected in higher profits in businesses that operate in the U.S. and, secondly, a rotation out of bonds at this time, with some money flowing across into equities. It is difficult to quantify the magnitude of this.

Looking more closely at the economics, Donald Trump avows to inject $1 trillion into the US economy, something which moves the focus away from monetary stimulus, which has been the backbone of policy response since the financial crisis. Infrastructure spend was one of the very few areas of policy where Hillary Clinton and Donald Trump agreed but the ambition of Trump's policy was the greater. His approach to bureaucracy – perhaps borne of his business past, is summed up in the statement that for every new federal regulation, two existing regulations must be eliminated. The benefit and intention here is clear but the implementation may not be so straightforward. He has singled out Dodd-Frank, the complex set of legislation introduced post-crisis that redefined the rules governing financial services in the country. This now looks like it will be re-worked rather than scrapped, another example of his pre-election rhetoric moderating. He plans to reform the corporate tax system, something which is recognised as not being fit for purpose. The headline rate is 35%, though companies' effective rates are generally much lower, and Trump wants to cut this to 15%. Such a move would be expansionary, creating jobs by freeing up capital within businesses of all sizes. He also wants to find a way for companies to repatriate the $2 trillion, or so, of retained profits that have been earned outside the U.S. but not brought back to the U.S. where they would be otherwise taxed heavily. Trump has suggested a one-off 10% tax rate on this money. Moving slightly out of economic policy and into social policy Trump is proposing scrapping the obligation of employers and employees to buy healthcare insurance. This, it could be argued, would reduce the cost of employment and give those employees more choice on how they spend the money but steps would need to be taken to ensure that Americans cannot neglect this particular need. Trump's overseas policy remains an enigma and, like much of the above, the detail is developing day by day. Despite 18 months of relentless campaigning surprisingly little detail emerged on policy during that period.

The direction of travel of the above would seem clear. Trump is a free-marketeer and a career in property development has, presumably, led him to value the principles of market access, pricing and the benefits of healthy competition. If this is correct, then he will see that the double-edged sword of interventionary politics can end up benefiting few. More experienced members of his new administration will presumably argue about the relative merits of entering into the retaliatory world of import tariffs and trade quotas. Another good example of where we will need to wait and see is his idea that jobs can be repatriated from abroad. Trump has highlighted Ford, which has opened various factories in Mexico which produce vehicles specifically for the U.S. market. Ford argues that it employs more people and produces more vehicles in the U.S. than its main rival but will continue to invest in Mexico. Were Trump to attempt to force Ford to build more factories in the U.S. he would surely be resisted by parts of Congress, lobby groups and trade bodies and it would be damaging to the reputation of the country as a free market economy. Any company that was prevented from maintaining production overseas would be facing higher costs, which inevitably would lead to higher factory gate prices. This would represent a serious encroachment into the market by government and would be a backwards step. There are good reasons to appeal to the worker but there are also good reasons to appeal to the owner of the business.

Regarding the infrastructure policy there is the question of funding. Detail, again, is scarce though the appetite for US government debt as a good credit risk is almost without parallel though $1tn. extra debt would increase the total debt pile by around 5%. There are alternative means of funding and one that has been suggested is that public pension funds (and non-public ones) could raise finance for toll roads and the like and derive a return from the usage of that piece of infrastructure. This could be along the lines of the privately funded parts of the péage system of French motorways and is common in countries like Canada and Australia. Earlier this year an Australian led consortium bought a bankrupt segment of toll road in Indiana with the California Public Employees Retirement System taking a 10% share. United States Treasury bills and bonds enjoy an unrivalled place in the investment world and the country's capacity to borrow is very high. The economic might of the country, its strong default history and having its own currency makes it an extremely good credit risk.

Whilst this month has been dominated by the Presidential election in the United States we must consider the position the U.K. currently finds itself in, particularly through the looking glass of the Autumn Statement. A Chancellor's first budget may be his easiest in that he or she can put distance from the decisions of predecessors. This Chancellor's job is dominated by two elements at present as he is encumbered with a very high level of debt and he needs to forecast, and then plan for, an event though he doesn't know when it will happen and can't know what the outcome will be. Both tax receipts and costs (such as contributions to the E.U.) are, at the best of times, difficult to predict but at this particular time any forecast will be interpreted as being unduly pessimistic or optimistic depending on the personal views of the commentator. Objectivity is particularly difficult at this time. Whilst the timetable of the negotiations and the negotiations themselves are 'known unknowns' they will play out against a backdrop of political instability within many of the negotiating E.U. countries. There are various layers of politics at play across Europe regarding the ongoing commitment to the European project and this commitment is to be tested in various national elections.

Most immediately on the 4th December Italy will hold its referendum on constitutional changes. A significant contributor to Italy's carousel politics, where they have had over 60 governments since the Second World War, is its government model where there are two chambers with more or less identical powers. Proposed legislation, drawn up in one house, must pass to the other for ratification. Any change to it will necessitate a re-reading and a fresh vote in the first house. The revised bill will then be passed again to the second house and the process could continue many times. Whilst the original intention was for the changes to the constitution to be put to the people, in offering to resign should he get a 'no' vote, the referendum has become more of a vote of confidence in prime minister Matteo Renzi's administration. He has since stepped back a little from this resignation threat though Italians seem still to be treating it as a vote of confidence. The new popular party, the Five Star Movement, led by ex-comic Beppe Grillo, seeks to pounce and the polls suggest prime minister Renzi is heading for defeat. The accuracy of these polls is subject to some speculation. Renzi has suggested that a ‘no’ vote would lead him towards a general election by the summer of 2017. Grillo is saying that a ‘no’ vote should lead to a national vote on the issue of whether to keep the euro. What has happened in other recent elections may influence the voting patterns of Italians and this may accentuate this fault line in the status quo. Italy is the fourth largest European economy but is in poor health. The country’s economy is around 8% smaller than it was before the financial crisis, its banks are burdened with around €300bn. of bad debts, the country itself has the highest level of debt in Europe and unemployment is very high at around 11.7%. These four facts are motivating the electorate to consider a new approach, buoyed by similar confidence in change in other countries. This uncertainty translates directly into market movements and in October, reflecting demand, the Republic of Italy issued a so-called Methuselah bond, an ultra-long dated government bond maturing in 2067. Its coupon is 2.8% and it sold for around €96.8 at launch meaning the yield to maturity for someone buying the bond and holding it until 2067 was around 2.95%. By the end of November, the yield had risen to 3.4% meaning the bond had fallen in value to €86.7. This represents a fall in value of 10.4%. It would take a high level of confidence to buy this bond today and expect it to regain its original price at any time in the foreseeable future. Widening slightly, the euro has weakened over the past six weeks as fast money has moved elsewhere.

Other uncertainties are at play here and also on the 4th December in Austria there is the re-run of the Presidential election. This is another event where voter disaffection may be clear to see. The President is largely a figurehead in the country but in this election it is the first time that neither main political party backs either of the candidates; the underlying story here is the rejection of both parties in the original ballot. Alexander van der Bellen is a Green and Norbert Hofer is from the Freedom Party of Austria. The original vote earlier this year was challenged in court and the result was thrown out, due to certain administrative errors in the counting. Van der Bellen won, but by a very narrow margin of around 30,000 votes. It will be interesting to see how the intervening six months, dominated by Brexit, Trump and Grillo, causes the popular vote to change. Hofer and the Freedom Party represent the right wing extreme and are primarily against the ‘Islamification’ of Europe, the entry of Turkey into the European Union but also seek significant reform of the E.U.

Approval ratings for the current President of France would by most commentators’ standards be described as disappointing and the reasons for them being so low are many and varied, but at the same time bound by similar factors. President Hollande promised voters that he could be measured by the fall in the level of unemployment, which has remained stubbornly high. France is a country which has chosen a different economic model from the UK and the US and is one where the rights and entitlements of workers at all levels are highly prized. In-work protection levels are high by international standards, pensions and benefits are generous and the 35 hour working week and a retirement age of 62 makes it an attractive country in which to work. There is a downside to this, in that France has not been successful at attracting direct foreign investment in the way neighbours such as the U.K. and Spain have. Unions yield a high level of power and can be very militant - despite union membership levels overall not being particularly high. The cost of creating jobs in France is higher than in many neighbouring countries inside and outside the eurozone. Job creation is a significant issue in the country and the government has had to spend more than it receives to maintain some economic momentum to the point that it has not balanced its budget since the 1970s. The French people are, of course, aware of the situation in which they find themselves and it would be easy to draw a short line from this national frustration to the selection of François Fillon as presidential candidate for the Republican Party - and favourite to become next President. In echoes of Margaret Thatcher he proposes to increase the working week, raise the retirement age and cut €100bn. from government spending. He also plans a cap on unemployment benefits and an end to the hated wealth tax, in which the State taxes the value of property, including jewellery and furniture, above a certain threshold. All of these would take France in a new direction and with a significant enough victory in the spring, he could be given a strong enough mandate to get these things done. Should that be the outcome, 2017 could be a year of significant unrest in the country with strikes and marches in protest at the changes though the resolve of the new leader would be galvanised by a strong victory. Now seems a popular time for countries to change course. Fillon claims that he is Frenchman first and foremost and is no europhile saying that the EU is "at best, ineffective, useless and irrelevant and at its worst as an obstacle to our development and freedom". He is more a reformer of Europe and wishes to see fiscal policy convergence and, eventually, pooling national debts. The situation the country finds itself in was encapsulated by November's announcement of its third quarter growth figures. GDP increased by 0.2% after contracting by -0.1% in the previous three months. Consumer spending was flat, which was somewhat surprising as consumer confidence is relatively high and low inflation is helping real wage growth. Other data was mixed and reversed what had happened in the second quarter.

Whilst the themes of immigration, self-determination and tax/spend are high on the list of considerations for voters around the world at present, there is also a burgeoning anti-globalisation movement. This poses a direct risk as anti-globalisation, in political terms, translates into protectionism which, in terms of policy, translates into tariffs, quotas and other restrictive practices. There was the recent high profile news story when the progress of the new E.U./Canada trade agreement, seven years in the making, was held up by a regional parliament in Belgium whose members were concerned that the accord represented further globalisation and underlined the ongoing threat to manufacturing and industrial jobs in the local area. A way through was found but the way politicians are choosing to amplify the concerns of voters could, if taken to its conclusion, create a far more difficult environment in which companies could do business. This can be used as a political message with no downside, which is very appealing in the cauldron of campaigning. Donald Trump's victory was due to his success in harnessing the blue collar vote in the fading industrial heartland of the country. Voters bought his message of America first, Americans first and threw around threats of import tariffs on Mexican products and Chinese steel. There are many clear risks to this policy and it is very difficult to see how the companies in which we invest could trade as successfully should there be a marked escalation of anti-trade sentiment. We mentioned earlier about the example of Ford and at this stage the biggest concern is how Donald Trump's politicking will translate into policy. So far, there has been significant moderation to his language and there are also the checks and balances that exist between the executive and legislature, Congress. Despite the Republicans now controlling both houses of Congress, there are many who would not automatically demur to Trump in his policy and in the Senate the Republicans' majority is slender.

It could be that at the time of writing there is an over-sensitivity to political rhetoric where big business is portrayed as a major contributor to social ill. Whilst government will necessarily need to establish and maintain the rulebook on what is or isn't fair competition it is the Meridian view that government intervention can represent a danger to markets, that it can quickly escalate into trade wars and that the consumer, rather than benefiting from the initial intention, is, in fact, prejudiced. This can take the form of higher prices, less choice or inferior products or services. To this can be added the uncertainty of not knowing what direction anti-competitive policy will take nor its unintended consequences.

This economic memorandum frequently refers to the IMF's World Economic Outlook and, in particular, its projections for year-on-year economic growth. Whilst accurate forecasting is invariably difficult, given the fast changing world in which we live, it is interesting to note the factors which the IMF cites as being influences on growth rates, the growth rates it projects, and how both of those data sets change over each six monthly period. An indication of how quickly things can change is illustrated by the fact that October's report pre-dates America's Presidential election and its views can already look a little out-dated. According to the report, growth is predicted to slow to 3.1% in 2016, before recovering to 3.4% in 2017. It has revised down both figures by 0.1% since April due to the 'subdued outlook for advanced economies'. It qualifies this by highlighting Brexit and slower growth in the United States (though markets have since priced in higher growth). It suggests that these developments have put further downward pressure on global interest rates, as monetary policy is now expected to remain accommodative for longer.

As we approach the year end, and in reference to the difficulty of making accurate economic projections, if we cast our minds back to the beginning of the year markets fell sharply in the first two months as investors fretted over plummeting commodity prices, the risk of a rapid slowdown in China and the much feared perils of deflation. The leading economic thinkers at Davos were in broad agreement that much was wrong in the world and that the consequences could be severe. Now, almost a year later, we see a different set of vulnerabilities but it is difficult to judge whether the current set of vulnerabilities is greater, less or about the same as those of early 2016. Commodity prices have risen from that low point, Chinese growth has slowed, but not unexpectedly, and world growth this year is forecast to be around 3.1% - below the long term trend but not unduly weak. It could even be said that, given the tumultuous events of the year, markets have been remarkably stable. In terms of Meridian's portfolios it is the weakness of sterling that has had the largest effect on valuations and this rise does not equate to an improvement in the quality of the underlying assets but rather a measuring adjustment but it underlines the importance of investing internationally and remaining unhedged.

As we approach the end of 2016 it is political uncertainties which lead the current list of concerns with the focus moving to Europe, and a busy period of voting. Political risk is flashing red on the dashboard and the return of inflation, with positive interest rate policy in the face of that risk, providing a new focus of attention. We have often advocated holding high yielding stocks and their consistent cash flows have proved very attractive over recent years. It is our view that interest rates will rise, but that the rise will be very gradual and the relative attractiveness of those dividends will only diminish very gradually. Should inflation start rising then company valuations should increase as those companies' revenue flows rise in line with the inflationary trend. It remains our view that investors should hold a diverse portfolio of international companies which have strong and resilient cash flows and the ability to develop their businesses and approach to markets in the face of the ongoing challenges. Political change is a constant but the possibility of an acceleration of the rate of change could prove to be a cause for concern and it could be particularly disruptive should sentiment against the euro grow. Again, diversification across sectors, geographies and companies provides some insurance against changes to the political landscape, though no strategy is infallible, we feel no reason to alter our asset allocation model at present which continues to favour equities. Despite their recent sell off, most bonds remain significantly overpriced.