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INVESTMENT MEMORANDUM

It has been a strong quarter for international equity investors, although those with a sterling base have enjoyed much lower, but positive, returns as sterling has staged a sharp recovery on the expectations that the Conservatives will be elected with a majority on the 12th December. That, of course, remains to be seen. On the other hand, fixed interest securities have moved lower, perhaps on expectations that the low point of this economic cycle has been reached. This also remains to be seen. In the foreign exchange market, sterling was stronger against all the major currencies. Gold, after a period of strength, moved modestly lower whilst the oil price rose modestly.

The tables below detail relevant movements in markets :

International Equities 30.08.19 - 29.11.19

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+5.0	-0.8	+5.4	+5.3
Finland	+2.7	-3.2	+2.8	+2.7
France	+7.4	+1.2	+7.5	+7.4
Germany	+10.0	+3.7	+10.2	+10.00
Hong Kong, China	+3.0	-3.0	+3.1	+3.0
Italy	+8.7	+2.5	+8.8	+8.7
Japan	+13.4	+3.5	+9.9	+9.8
Netherlands	+7.0	+0.9	+7.1	+7.0
Spain	+5.8	-0.3	+5.9	+5.8
Switzerland	+5.0	-2.2	+3.9	+3.8
UK	+3.2	+3.2	+9.6	+9.5
USA	+8.0	+1.7	+8.0	+7.9
All World Europe ex UK	+7.3	+1.0	+7.3	+7.2
All World Asia Pacific ex Japan	+5.6	+0.3	+6.5	+6.4
All World Asia Pacific	+8.6	+1.5	+7.8	+7.7
All World Latin America	+4.6	-3.3	+4.6	+2.6
All World All Emerging Markets	+5.3	-0.4	+5.8	+5.7
All World	+7.5	+1.4	+7.7	+7.6

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -2.2%

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

Currency	30.08.19	29.11.19
Sterling	0.32	0.70
US Dollar	1.50	1.78
Yen	-0.32	-0.09
Germany (Euro)	-0.70	-0.36

Sterling's performance during the quarter ending 29.11.19 (%)

Currency	Quarter Ending 29.11.19
US Dollar	+6.3
Canadian Dollar	+6.1
Yen	+9.3
Euro	+6.0
Swiss Franc	+7.3
Australian Dollar	+5.7

Other currency movements during the quarter ending 29.11.19 (%)

Currency	Quarter Ending 29.11.19
US Dollar / Canadian Dollar	-0.1
US Dollar / Yen	+2.9
US Dollar / Euro	-0.3
Swiss Franc / Euro	-1.2
Euro / Yen	+3.1

Significant Commodities (US dollar terms) 30.08.19 - 29.11.19 (%)

Currency	Quarter Ending 29.11.19
Oil	+2.6
Gold	-5.6

MARKETS

It has been a positive quarter for international equity markets, although the strength of sterling has pared back sterling returns considerably. The total return on the FTSE All World Index was +7.5% in local currency returns, +1.4% in sterling terms, +7.7% in US dollar terms and +7.6% in euro terms. Looking at local currency returns first, the most positive return came from Japan where the FTSE Japan Index returned +13.4%. The most notable underperformer was the UK where the FTSE UK Index returned +3.2%, hardly, though, a disappointing performance in absolute terms. The picture changes, however, in sterling terms where the UK showed relative strength against the FTSE All World Index, its return of +3.2% comparing favourably with the +1.4% return on the FTSE All World Index. Japan still came out relatively well with its +3.5% return of the FTSE Japan Index in sterling terms and comfortably exceeded the return on the FTSE All World Index. The weakest performer in sterling terms was the FTSE All World Latin American Index which returned -3.3%.

In the international government bond markets, as measured by benchmark ten year government bond yields, there has been a reversal of the downward trend in yields as investors have felt more confident that the world economy is near the low point in the current cycle, although that, of course, remains to be seen. In the sterling government bond market, the gross redemption yield on the ten year UK gilt rose by 38 basis points to 0.70%. In the US Treasury bond market, the yield rose by 28 basis points to 1.78% and in the Japanese government bond market, the yield rose by 23 basis points to -0.09%. The yield on the German Bund rose by 34 basis points to -0.36%.

Sterling strengthened considerably as the chances of a resolution of the political gridlock which has blocked Brexit were considered to have increased after Parliament finally agreed to overrule the Fixed Term Parliament Act and hold a General Election on 12th December. Guided by opinion polls showing the probability of an overall Conservative majority, sterling has strengthened, although, given what happened in 2017, investors should be suitably cautious about calling the election result. Against the yen, sterling rose by 9.3%, against the Swiss Franc by 7.3%, against the US dollar by 6.3%, against the Canadian dollar by 6.1%, against the euro by 6.0% and against the Australian dollar by 5.7%.

In the commodity markets, oil, as measured by Brent crude, rose by 2.6% and gold, after a strong run, fell back by 5.6%.

ECONOMICS

International equity markets, at least for the moment, are brushing aside the political and economic concerns which dominate the investment scene. Many markets are close to all time highs at present. Market movements are influenced on a day to day basis by the latest news on the US/China trade talks which, on some days, appears more promising and, on others, less so. Increasing protectionism, evidenced either by increased tariffs or quotas, or both, is unequivocally bad for the world economy as it will lead to slower economic growth, with collateral damage for company profits and dividends, both being drivers for share prices. It is not only a USA/China issue as the acrimonious dispute between the USA and EU over Airbus subsidies shows. The political mood in the USA, evidenced by the actions of President Trump and some of the leading candidates for the Democratic Presidential nomination, is swinging towards protectionism. Whilst the day to day fluctuations in share prices

reflect the latest news, the overall performance of share prices suggests that investors are quite sanguine about the eventual outcome. Are they right to be so and what might be their reasons for feeling confident? It probably all boils down to protectionism. If economic growth slows as a result of the trade war, it is not likely to be good news for President Trump or President Xi. Given the different political systems in the two countries, it might be thought that the threat to President Trump was the greater one in the short term because he is facing re-election next year. Notwithstanding all the “noise” around President Trump, the economy is likely to be the major influence on voters’ preferences, so an unsatisfactory growth rate caused by the negative effect of increased tariffs will not be helpful to his chances. President Xi does not, of course, face such immediate pressures but, having accumulated so much power and facing issues such as the unrest in Hong Kong, a reduction in the economic growth rate with the resulting effects on employment, could raise the pressures on him. The longer the dispute lasts, the more likely it is that trade patterns will become distorted and ultimately change and supplies previously sourced from China perhaps being replaced by those from, say, Vietnam. The Chinese economy is being reorientated away from fixed asset investment and exports towards consumption and services which will involve an economic slowdown, even without the current disruption, so China will not want this trend to be accelerated by the fallout from the current dispute.

All this is supposition supporting the recent strength of international equity markets, but what is actually happening to the world economy at present? The latest OECD Economic Outlook projections were published in November and they, in common with other recent economic forecasts, represent a downgrade on previous ones. The OECD now forecasts that the world economy will grow 2.9% this year and the same next year, this latter projection being a downgrade on its previous one. Within that overall projection, it has downgraded its estimate for the USA this year to 2.3% whilst keeping its projection for 2020 at 2.0%. The eurozone has seen its forecasts raised to 1.2% for this year and 1.1% for next year. Within that, there has been a slight uptick in its forecast for Germany this year to 0.6% growth but next year’s forecast has been reduced to 0.4%. Relatively speaking, France’s performance within the eurozone is quite good in relative but not absolute terms, with growth forecasts remaining unchanged for 2019 at 1.3% and for 2020 at 1.2%. Italy has seen a small increase in its forecast this year to 0.2%, whilst next year’s forecast remains unchanged at 0.4%. These eurozone forecasts, collectively, are pretty weak, however. Forecasts for the UK have been increased for 2019 and 2020 to 1.2% and 1.0% respectively. The OECD raised its growth forecast for China this year to 6.2%, but it remains unchanged for 2020 at 5.7% and a further decline in the pace of growth is expected in 2021 at 5.5%. India, where economic conditions appear to be deteriorating, has seen its projections for 2019 and 2020 reduced to 5.8% and 6.2% respectively. Looking further ahead to 2021, the OECD sees only a very mild increase in world economic growth to 3.0%.

How do we assess these growth rates, assuming the OECD’s estimates are somewhere near the mark and recent downgrades in forecasts by various organisations are now halted? They show that the world economy is growing somewhere near stall speed and a continuation of the trend of downgrades could mean that a recession is on its way. But we are not there yet, and so it would not be right to be too pessimistic and the OECD is not forecasting a recession. It is probably correct to say that, if the trade war ratchets up much further, there is a high chance of a recession as world trade growth slows down, stalls or goes into decline. On the other hand, if some reasonable deal between the USA and China can be reached, economic growth will probably accelerate and the risk of recession recede. It is the latter case which international equity markets have been reflecting.

Unless anything dramatic happens in December it looks like being a strong year for international equities, yet this has been achieved against a modest international growth rate and flattish corporate earnings. Price/earnings multiple expansion cannot continue indefinitely and share prices will need the “earnings” part to accelerate. What has undoubtedly sustained and propelled share prices upwards has been their relative income attractions. We have written about this many times but we think shares’ performance has been driven by the extreme monetary policies being pursued by central banks around the world. Historically, fixed interest securities have been bought for their income attractions, say a

4% or 5% yield, whilst shares on lower dividend yields have been bought for their growth prospects. Although bond yields are off their low point, those shown on the table at the beginning of this review would literally have been thought incredible before the financial crisis. Furthermore, as monetary policy has recently been eased further in some countries, such as the USA or in regions such as the eurozone, it does not look at all likely that bond yields will rise significantly in the near future. An indication of the difference between ten year government bond yields and the dividend yields in their respective equity markets is instructive.

Country	10 year Government Bond yield	Typical equity dividend yield
	%	%
U.S.A.	1.816	1.86
U.K.	0.742	4.98
Germany	-0.312	3.11
Japan	-0.042	1.93

Figures at 09.12.2019

Apart from the USA, where the difference is small, the gap is significant and undoubtedly some income seekers, who would traditionally have looked to fixed interest securities or cash to provide their income requirements, have turned to shares as an alternative, and this has helped to raise share price levels. But even in the USA, where the gap is small, it is still an unusual relationship and, given that dividends can be expected to rise over time, it still highlights the relative attraction of shares. This is not the best reason for share prices to be strong but, realistically, the world economy is finding it very difficult to grow at anything other than a very modest level, even with negative or very low interest rates, so raising interest rates towards historically normal levels would be likely to push the world economy into recession. So, we have the situation where monetary policy is likely to support share prices for the foreseeable future because of the level of their dividend yields. Dividend levels, in the absence of a recession, look fairly stable, so the support which these provide look likely to be sustained.

However, whilst holders of bonds might feel comfortable with holding them in the short term, a reality check is necessary. At the moment, there are about US\$11.3 trillion worth of fixed interest securities sitting on negative yields. This means that an investor buying these bonds now and holding them to maturity will realise a certain loss. As an investment manager, it is hard to grasp why any long term investor can make a conscious decision to buy an investment which will lose money. Even in the positive yielding markets like the UK and USA, the ten year government yield returns of 0.74% and 1.82% (at 09.12.2019) would represent a very low hurdle for a return which might be deemed satisfactory. Those bonds at anything but the very short end of the market are very vulnerable when interest rates eventually start to rise and the further out along the yield curve one goes the higher the capital risk. The historical view that bonds are less risky than equities needs to be challenged in the current environment. Whilst there may not be a qualitative risk with good quality bonds, there is an investment risk arising from rising interest rates which could lead to some significant capital losses. Whilst, in certain circumstances, rising interest rates could hit equity prices, in the long term, as we have seen in the past, share prices could be expected to recover and move ahead. So, in current circumstances, as a result of current monetary policy, bonds can be reasonably considered more risky than equities over the medium and long term.

What seemed like an emergency move after the financial crisis over ten years ago is now developing an air of permanence. For borrowers, it may seem good news that interest rates are so low but for savers, who might traditionally hold cash on deposit or bonds for the interest rates they pay, it has created difficulties. The danger for savers is that the search for yield raises the risks as they chase assets which,

on the face of it, provide above average yields. Just one example is in the mini bond market in the UK, where the “too good to be true” interest rates offered proved to be just that in some cases. That is why, for those who need income, buying good quality shares, say an exchange traded fund covering the FTSE 100 Index with a yield of just under 5%, has some attractions subject to the UK political risk, which we will discuss later. It would seem a more attractive long term investment than a fixed interest security. That is the position for individuals, but what about the effect on the wider economy? On the negative side, it makes it easier for struggling, sometimes called zombie, companies to survive since they can service their interest costs even if they may not be able to repay the principal. For those who work in these companies, that is clearly good news, but the second order effects for the economy are negative. Zombie companies crowd out the successful companies, making it more difficult for them to grow. Repeated across an economy, this reduces the potential growth rate and adversely affects productivity growth which makes it more difficult for real wages to increase. Whilst the first order effects may seem positive, second order effects work the other way. Also acting as a brake on growth, is the effect which low or negative interest rates have on banks. They act as a margin squeeze because of the push back from customers to negative interest rates on their deposits, whilst borrowers expect to obtain the benefit of lower interest rates. Lower profitability makes it more difficult for banks to build up their capital base at a time when regulators are demanding that capital levels be increased. This effect crimps banks’ lending ability either qualitatively (to perhaps more marginal borrowers) or quantitatively (in the amount banks are prepared to lend). For the world economy as a whole, extreme monetary policy is becoming an addiction. The world economy needs to be weaned off ultra low or negative interest rates, but it is difficult to see how this can happen in the foreseeable future. The USA was the first major country to start raising interest rates in this current cycle, but it has now had to backtrack three times and cut interest rates. In the face of feeble eurozone economic growth, the eurozone has started its asset purchase scheme again and reduced interest rates. But, as explained above, current interest rate levels are not conducive to raising economic growth rates and it is faster economic growth which would provide a catalyst for higher interest rates.

If monetary policy cannot simulate economic growth after so many years at low or negative interest rates, what about the other aspect of economic policy, fiscal activity? Here there is some limited scope in the eurozone at least, with Germany and the Netherlands both running budget surpluses and having large current account surpluses. Although there are some signs of a change in attitude in Germany towards using its strong financial position to give a fiscal boost, long standing and constitutional objections to running a budget deficit make it difficult. There is no doubt that a fiscal boost, especially from Germany as the much larger economy, would be helpful at a time when eurozone monetary policy is maxed out. But elsewhere, amongst the major nations, there is very little room for manoeuvre on fiscal policy. One of the surprising aspects of recent economic data is that inflation has not responded to the enormous monetary stimulus. With the size of money creation, one would normally expect inflation to have picked up, but the money has not moved around the economy as expected, with the part of it placed with central banks not doing anything to stimulate the economy. Whilst low inflation is, in many ways, a good thing, it can also have a negative economic effect, such as has been seen in Japan in the past. If prices are falling, or even rising only very slowly, consumers have little incentive to spend on discretionary items, knowing that the price will change very little if they delay. This can create a downward spiral in an economy. Central banks are, therefore, desperate to use whatever monetary firepower they have to try to get their economies to reach their inflation target. However, almost certainly they are almost out of fire power to achieve much more, with their actions increasingly leading to diminishing returns. What makes their task more difficult is the trade tensions.

What we are left with is the conclusions we have reached over many months as far as our investment policy is concerned, namely that, unless an investment mandate dictates otherwise, we should be drawn towards equities as the preferred asset class. In one sense, this is because fixed interest securities look such poor value and when, as there must be sometime in the longer term notwithstanding what we have said above about shorter term prospects, there is some move towards normality in interest rates, there will be some significant declines in bond prices. We would not want to buy an asset which we know for certain is bad value. The situation is slightly, but not much, different for cash. We have

allowed modest percentages of cash to build up in our portfolios through dividend receipts in the hope of being able to purchase more assets on a significant market setback. That seems reasonable to us, but to hold cash as an asset class as a large percentage of a portfolio as opposed to equities, is more problematic as it risks a significant opportunity cost if equities move higher which, in the medium and long term, they are likely to do. Even at current low inflation levels, cash will provide a negative real return, which is acceptable if one has a strong conviction that markets are likely to fall sharply. With the trade disputes dominating the background at present, the risk is not trivial, but it is not our central view at present. That leaves equities which remain our preferred asset class. If we are right about interest rates remaining very low or negative and the economic outcome is close to what the OECD is projecting, then we think that it is reasonable to continue to prefer equities. After what looks like being a strong year for equities, we expect some negative quarters, given the uncertain background, but the preference for equities is our central case. We appreciate that the reason equities have performed well is not the best quality one, i.e. very low or negative interest rates making equities a yield attraction, but it is likely that monetary policy will remain very loose for the foreseeable future.

For sterling based investors, the UK General Election on 12th December will be crucial in determining their investment policy. It is the most important General Election for a long time because of the gulf in the economic thinking of both major parties. The Labour manifesto, by UK standards, is more extreme than any manifesto produced in the UK, with hostility towards investors and businesses running through its manifesto. It is not making a political judgement to say that, if it was to form the next government and enact its manifesto, the outlook for the UK stock market and sterling would be very poor. A hung parliament would also adversely affect the UK stock market because of the uncertainty that would continue to endure. If the current government were to return with a majority, it is likely that UK markets would rise, perhaps quite sharply, as underperformance caused by Brexit and the political uncertainty was made up. This is why, earlier in this review, we referred to the attractive yield on the FTSE100 index. From an economic aspect, there is anecdotal evidence that many business decisions have been held up because of the political uncertainty in the UK. If the government is returned with a majority, we would expect, at least in the short term, an upturn in UK economic activity. We have long felt the political risk in the UK far outweighed the negative aspects of Brexit. After what happened in 2017, it is not advisable to assume anything about the outcome of the General Election and our widely diversified international portfolios provide the necessary insurance policy as well as following prudent portfolio construction rules. Whatever the opinion polls might say, risk aversion in the UK is paramount.

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