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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

The strength of international equity markets over the quarter reflected a very strong November on the back of good news about potential vaccines for Covid-19. Nowhere in our table below was there a negative performance. Overall, bond movements as measured by ten year government bonds were relatively slight. Foreign exchange markets showed strength in the yen over the quarter. In the commodity markets, news about the vaccines helped oil shares on the back of hopes of resumed economic growth.

The tables below detail relevant movements in markets :

International Equities 31.08.20 - 30.11.20

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+8.6	+8.5	+8.2	+8.1
Finland	+4.8	+5.1	+4.8	+4.8
France	+11.1	+11.4	+11.1	+11.1
Germany	+2.0	+2.3	+2.0	+2.0
Hong Kong, China	+5.1	+5.4	+5.1	+5.0
Italy	+11.3	+11.6	+11.3	+11.3
Japan	+9.8	+12.0	+11.7	+11.6
Netherlands	+10.9	+11.3	+11.0	+10.9
Spain	+16.9	+17.3	+17.0	+16.9
Switzerland	+2.4	+2.1	+1.8	+1.8
UK	+5.8	+5.8	+5.5	+5.5
USA	+4.4	+4.7	+4.4	+4.4
All World Europe ex UK	+7.2	+7.4	+7.1	+7.0
All World Asia Pacific ex Japan	+8.2	+9.8	+9.5	+9.5
All World Asia Pacific	+8.8	+10.6	+10.3	+10.3
All World Latin America	+10.7	+14.8	+14.4	+14.4
All World All Emerging Markets	+7.4	+9.0	+8.7	+8.6
All World	+5.8	+6.5	+6.2	+6.1

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +0.5%

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

Currency	31.08.20	30.11.20
Sterling	0.31	0.30
US Dollar	0.71	0.84
Yen	0.04	0.01
Germany (Euro)	-0.40	-0.57

Sterling's performance during the quarter ending 30.11.20 (%)

Currency	Quarter Ending 30.11.20
US Dollar	-0.3
Canadian Dollar	-0.6
Yen	-1.7
Euro	-0.3
Swiss Franc	+0.3
Australian Dollar	+0.1

Other currency movements during the quarter ending 30.11.20 (%)

Currency	Quarter Ending 30.11.20
US Dollar / Canadian Dollar	-0.5
US Dollar / Yen	-1.4
US Dollar / Euro	-0.1
Swiss Franc / Euro	-0.4
Euro / Yen	-1.4

Significant Commodities (US dollar terms) 31.08.20 - 30.11.20 (%)

Currency	Quarter Ending 30.11.20
Oil	+3.4
Gold	-9.1

MARKETS

It has been an extraordinary quarter for international equity markets. A generally very strong performance hides the fact that the, hopefully, good news on the vaccine front propelled total returns of between 8.9% and 12.4% in the FTSE All World Index in November, the range reflecting the currency adjusted returns in the main currencies.

Over the quarter, the total return in local currency terms on the FTSE All World Index was +5.8%, in sterling terms, +6.5%, in US dollar terms, +6.2% and, in euro terms, +6.1%. Looking, firstly, at local currency returns, the strongest performance came from the FTSE All World Latin America Index which returned +10.7%. There were also above average performances from the FTSE Japan Index, +9.8%, the FTSE Australia Index, +8.6%, the FTSE All World Asia Pacific ex Japan Index, +8.2%, the FTSE All World All Emerging Markets Index, +7.4%, and the FTSE All World Europe ex UK Index, +7.2%. Within the latter, there were some spectacular movements, notably from Spain where the FTSE Spain Index returned +16.9% over the quarter. The UK performed in line with the FTSE All World Index but, on this occasion, the FTSE USA Index slightly underperformed it with a still excellent return of 4.4%. With sterling mostly slightly weaker in the foreign exchange market, returns were generally slightly higher in sterling terms, with the FTSE All World Latin America Index a feature with a return of +14.8% and the FTSE Japan Index with a return of +12.0%.

Looking at the ten year government bond market, there was not a great deal of change. The gross redemption yield on the UK government bond fell by just 1 basis point to 0.30%, on the Japanese Government Bond by 3 basis points to 0.01% and, on the German Bund, by 17 basis points to -0.57%. The US Treasury Bond went in the other direction with the gross redemption yield rising by 13 basis points to 0.84%.

As mentioned above, sterling was slightly weaker overall this quarter. Against the yen it fell by 1.7%, against the Canadian dollar by 0.6% and against the US dollar and euro by 0.3%. On the other hand, it rose slightly against the Swiss Franc and Australian dollar by 0.3% and 0.1% respectively.

In the commodities market, good news on the vaccine front and a strong performance from shares diminished the attraction of gold, which fell by 9.1%. On the other hand, the prospects of an economic recovery helped the oil price, with Brent crude rising by 3.4% over the quarter.

ECONOMICS

In this most remarkable of years, it may seem strange to some people that, after eleven months, equity indices overall have shown a positive return against the background of a severe recession caused by Covid-19. After all, the consequences for many companies have been dreadful in financial terms and, in some unfortunate cases, terminal, leading to substantial increases in unemployment. Profits and dividends have fallen in many cases, with some countries being affected more than others. All in all, the background has been dire for both public health and the world economy and, yet, many markets are ahead of their value at the end of 2019.

In our reviews each month since February, when the coronavirus outbreak really captured investors' attention, we have outlined, firstly, why investors should look ahead rather than at the ghastly public health and economic position which was then unfolding, and, secondly, why, even after a significant recovery, equities remained our preferred asset class. That was the story right through from 23rd March when share prices reached their low point. Then, in November, the background support for securities received its biggest boost yet when news of the successful results from the Pfizer Inc./BioNTech SE

vaccine were announced. As this is written, the UK regulator, the Medical and Healthcare Products Regulatory Agency, has given emergency authorisation for the deployment of the vaccine, saying that it “met its strict standards of safety, quality and effectiveness”. Two further boosts to investor sentiment came from successful trials of Moderna Inc.’s vaccine and the one from AstraZeneca/Oxford University. With news from other trials still to come, there must be a good chance that the virus will come under manageable control in 2021 and that some sort of normality will come back to personal and economic life. This prospect is what has powered international equity markets in November, with the total return on the FTSE All World Index being +8.9% in sterling terms and +11.5% in local currency terms. If the vaccines prove to be successful in curbing the virus in 2021, it is not difficult to imagine quite a sharp bounce back in economic activity. Whilst many people have sadly lost their jobs or businesses, those who have remained in work or maintained a steady income in 2020 will have seen their savings build up as spending activities were limited during the lockdown. A rush of spending by those fortunate enough to be in that position would be a significant boost to certain sectors, with leisure one which immediately comes to mind. More certainty for business could be expected to lead to higher business investment. After a dearth of good economic news, the prospect of better times has excited investors, and some markets like Wall Street are currently at an all time peak. If the potential promise of the vaccines is upheld, economic activity could surprise on the upside.

The OECD has just published its December 2020 Economic Outlook and, given that it has been published in December, next year’s forecasts take on added importance. Against a decline of 4.2% in GDP growth for 2020, it expects growth of 4.2% in 2021 and 3.7% for 2022. The only country for which it sees growth in 2020 is China, at 1.8%, followed by 8.0% in 2021. China has been the most successful country in getting on top of the virus and returning to a near normal position. Elsewhere, it sees the USA contracting by 3.7% this year before growing by 3.2% next year. The euro area is forecast to contract by 7.5% this year and recover by 3.6% next year. Japan is expected to contract by 5.3% this year and to grow by 2.3% next year. The UK is expected to contract by 11.6% this year and to recover by 4.2% next year. Relative to China, India will underperform considerably as it continues to be badly affected by the pandemic. It is forecast to contract by 9.9% this year and recover by 7.9% next year. Apart from China, amongst OECD members, only Indonesia, South Korea and Turkey will end 2021 with GDP higher than at the end of 2019, such is the damage that the pandemic has inflicted on the world economy.

These are not the sort of economic numbers which would normally provide the background to a strengthening stock market. It is, of course, true that markets look ahead and discount what they think they can see ahead. However, what it could not have foreseen was a sudden pandemic, hence it did not have time to discount it and the precipitous fall between late February and late March. Now, it can reasonably foresee better times, given the vaccine news, but it is from much elevated levels which have not been validated by corporate earnings in 2020 which have been badly affected by the pandemic.

The answer to this puzzle of rising stock markets, besides the encouraging vaccine news in November, remains, as has been the case for a long time, the extraordinarily loose monetary policy which has been turbocharged through the pandemic, aided by the fiscal taps being turned on to an equally extraordinary degree. Inevitably, and rather awkwardly for politicians at a time when many people are suffering financially as well as healthwise from the pandemic, this has leaked into asset prices. In an economic sense, a strong stock market can be positive for an economy because it creates a positive wealth effect which can encourage individuals to spend and businesses to invest. The political problem, as it has been for some time, arises from the fact that loose monetary policy has raised asset prices at a time when many people are facing financial difficulties. Investors and the corporate sector could be a political target for tax measures.

The result of the upward pressure on asset prices has meant that there are some elevated share price ratings. The S & P 500 index, for example, is on an estimated forward price/earnings ratio of around 26. Next year’s earnings will show some scars from the financial effects of the pandemic so earnings

are still likely to be lower than they would otherwise have been. In the absence of the pandemic for the year after, the forward price/earnings ratio is forecast to be over 21. The NASDAQ index is even higher, as might be expected, with figures of around 40 and 30.

We have explained before why we think that these figures can be justified in these highly unusual circumstances, these being the extraordinarily low level of interest rates which have effectively been underwritten by central banks for the foreseeable future. The relationship between equity yields, even on reduced dividends, and bond yields remain favourable for equities. So, for example, the dividend yield on the S & P 500 Index is currently showing at 1.65%, about 70 basis points higher than on the US Treasury Bond. In Germany, the dividend yield on the DAX of 2.7% compares very favourably with a negative yield on the 10 year German Bund of 0.52% and so it goes on. Only in China, of major economies, is the relationship which one used to expect. There the ten year government bond yields about 3.3%, well above the yield on the CSI300 Index of 1.76%. It is not surprising that the Chinese government bond market is proving popular with overseas investors.

Looked at mathematically, very low interest rates, as measured by the risk free rate, raise the net present value of future company earnings. That is a positive for share prices, particularly as we have comfort that interest rates are going to remain low for a very long time. One of its negative side effects is that it raises the liabilities of pension funds and makes increased calls on companies to put money into their pension funds, thereby diverting money from investment.

It is important to keep the situation in perspective at a time when stock markets are trading strongly. We maintain our positive stance on equities because of the outlook for interest rates and in the hope and expectation that 2021 will be much better for the world economy. However, in the medium and longer term, we have to be realistic about the challenge facing policymakers, given the astronomic sums spent on stabilising economies. Quoting from OECD statistics, it is worth showing the effect on governments' finances of their fiscal measures to support their economies during the financial crisis both in terms of the budget deficit and outstanding public debt as a percentage of GDP.

If we look at the euro area, the OECD estimates that it will move from a budget deficit of 0.6% in 2019 to one of 8.6% in 2020 and that government debt as a percentage of GDP will rise from 85.9% of GDP in 2019 to 101.8% in 2020. This is on the Maastricht definition of general government debt as a percentage of GDP. The figures get worse in later years. On the OECD definition of general government gross debt as a percentage of GDP, which gives a higher figure than some other countries produce on their own calculation method, the relationship with the pandemic costs is clear, just as it is for the eurozone. For the USA, the OECD has its budget deficit rising from 6.7% of GDP in 2019 to 15.4% in 2020 and general government gross debt rising from 108.4% of GDP in 2019 to 128.0% in 2020. For the UK, the budget deficit moves from 2.4% of GDP in 2019 to 16.7% in 2020, whilst general government gross debt moves from 117.3% of GDP in 2019 to 145.3% in 2020. For Japan, the budget deficit grows from 2.6% of GDP in 2019 to 10.5% in 2020, whilst general government gross debt is forecast to rise from 225.3% in 2019 to 241.6% in 2020. By contrast, the figures for China look much less alarming, with the general government financial balance rising from a deficit of 3.7% in 2019 to a deficit of 6.9% in 2020. We noted earlier in this review that China was showing the best economic performance and that this is reflected in the relatively strong state of government finances. What is clear is that whatever the definitions used for the different governments' finances, the cost of Covid-19 is astronomic and, at some stage, governments will have to decide how they deal with this legacy. That discussion is for another day. For the moment, because central banks are hoovering up government bonds and interest rates are artificially depressed, it is manageable. The malign effects of artificially low interest rates and the explosion in the size of central banks' balance sheets are considerable. For the moment, it seems inevitable that very loose and unorthodox monetary and fiscal policy will continue in order to safeguard the relevant economies, but the distortions it causes are unwelcome. Savers are penalised at the expense of borrowers, with the risk that the search for return in place of interest income that savers would have seen in the past can encourage speculative activity and asset bubbles. Companies with no good prospects are kept alive, because they can service their

debts but perhaps not repay the principal. This penalises companies with better prospects. Then there is the effect on pension funds with low interest rates raising companies' pension fund liabilities which means top ups coming from funds which could be used for investment.

The pandemic, of course, dominates the news and there is a realistic hope that 2021 will see the corner turned in terms of at least taming it, so that some semblance of normal life can be resumed, both for individuals and the corporate sector. In any other circumstances, the news would most likely be dominated by last month's US elections for President and Congress and what it meant for investors. Whilst there is no doubt who won the Presidential election, the Democrats performed unexpectedly poorly in the Congressional elections, losing seats but retaining control of the House of Representatives and quite possibly failing to gain control of the Senate. With 50 seats so far in the Senate, the Republicans only need to win one of the two Georgia run off elections in January to retain control. Whilst the Presidential election inevitably attracts everyone's attention, the checks and balances in the US Constitution mean that control of Congress is very important if a President wants to implement his agenda. Wall Street's reaction to the election results is instructive. It moved sharply ahead, probably on the basis that a gridlocked Congress would not be able to implement radical Democrat policies. The Democrats embrace a wide spectrum of views, stretching from the radical left to the centre or centre left where President elect Biden probably sits. If the Republicans retain control of the Senate and more radical policies cannot therefore be implemented, that is probably a good place for the stock market. Prior to the outbreak of the pandemic, the US economy was performing well and investors would want to revert to that position and not see measures which could upset the position they thought that they were in. The results of the Georgia run offs on the 5th January may be quite significant for the market. If the Democrats were to win both seats, leaving a tied Senate, the casting vote would come from the Vice President, effectively giving control to the Democrats.

Back in the UK, the sound and fury of the Brexit debate in 2019 preceding the General Election has rather been lost in the far bigger event in 2020, the Covid-19 pandemic. With the deadline for a trade agreement between the UK and EU drawing close, it is difficult to know which way it will go but it is fair to say that, in the short term, any economic impact of a "no deal" outcome will be dwarfed by the cost of the measures taken to support the UK economy through Covid-19. As the OECD forecasts for the budget deficit show, the UK economy has been one of the worst affected.

A "no deal" would not be good for the EU either given its large trade surplus with the UK but politics could trump economics and a rational solution might fall victim to politics. For the moment, the UK market has shown some recovery after a dreadful year compared to other major markets with its value orientation coming to the fore after being so out of favour for so long. If the world economy shows a good improvement next year on the back of a successful vaccination programme, value stocks could lead the way in any further market improvement.

As we approach the end of a remarkable year for investors, those who held their nerve look to have achieved a satisfactory return. We have not really mentioned the fixed interest market, but our view on it remains the same, namely that there is no value in it and the potential for some significant losses given the minuscule yields and negative ones in much of Europe. Bond markets face a lot of headwinds in the future, obvious ones being a rise in interest rates as central banks unwind their monetary policy and scale back their bloated balance sheets as a result of quantitative easing. Whilst equities have generally performed well, we have explained why the sometimes lofty valuations can be justified. However, the background remains uncertain and we must expect quarterly fluctuations in share prices, possibly quite sharp ones and some negative quarters. But long term investors can take these in their stride and concentrate on that time horizon, rather than being fazed by the events of February and March. Those who did stand back from the position then have been well rewarded with less than a month of the year to go.

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