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ASSET MANAGEMENT (C.I.) LIMITED

## INVESTMENT MEMORANDUM

International equity markets retreated at the end of the quarter on news of the discovery of the Omicron variant to leave markets little changed over the quarter, although, for sterling investors, there was a small positive return. International bond markets were mixed and, in the foreign exchange market, sterling was generally weaker except against the euro. In the commodity markets, oil fell back at the end of the quarter on news of the Omicron variant.

The tables below detail relevant movements in markets :

### International Equities 31.08.21 - 30.11.21

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	-2.8	-1.9	-5.7	-1.1
Finland	-4.2	-5.0	-8.7	-4.2
France	+0.9	N/C	-3.8	+0.9
Germany	-5.5	-6.2	-9.8	-5.5
Hong Kong, China	-9.7	-6.3	-9.9	-5.5
Italy	-0.1	-0.9	-4.7	-0.1
Japan	-0.6	+0.1	-3.8	+0.9
Netherlands	-2.9	-3.7	-7.4	-2.9
Spain	-5.6	-6.3	-10.0	-5.6
Switzerland	-2.2	+0.7	-3.2	+1.6
UK	-0.7	-0.7	-4.6	+0.1
USA	+0.8	+4.9	+0.8	+5.7
All World Europe ex UK	-2.1	-2.2	-6.0	-1.4
All World Asia Pacific ex Japan	-4.9	-2.4	-6.2	-1.6
All World Asia Pacific	-3.4	-1.6	-5.4	-0.8
All World Latin America	-10.6	-14.9	-18.2	-14.3
All World All Emerging Markets	-3.8	-2.1	-5.8	-1.3
All World	-0.5	+2.2	-1.7	+3.1

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.3%

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

Currency	31.08.21	30.11.21
Sterling	0.71	0.81
US Dollar	1.31	1.45
Yen	0.02	0.05
Germany (Euro)	-0.19	-0.35

## Sterling's performance during the quarter ending 30.11.21 (%)

Currency	Quarter Ending 30.11.21
US Dollar	-3.2
Canadian Dollar	-2.0
Yen	-0.3
Euro	+0.8
Swiss Franc	-2.8
Australian Dollar	-0.7

## Other currency movements during the quarter ending 30.11.21 (%)

Currency	Quarter Ending 30.11.21
US Dollar / Canadian Dollar	+1.5
US Dollar / Yen	+2.9
US Dollar / Euro	+4.4
Swiss Franc / Euro	+3.8
Euro / Yen	-1.5

## Significant Commodities (US dollar terms) 31.08.21 - 30.11.21 (%)

Currency	Quarter Ending 30.11.21
Oil	-4.2
Gold	+0.3

## MARKETS

A pull back at the end of the quarter following news of the discovery of the Omicron variant meant that there was little change in market levels over the quarter.

Looking at equity markets firstly, the total return on the FTSE All World Index in local currency terms was -0.5%, in sterling terms +2.2%, in US dollar terms -1.7% and, in euro terms, +3.1%. In local currency terms, the best performance came from the FTSE USA Index with a return of +0.8% and the weakest return was from the FTSE All World Latin America Index with a return of -0.5%. Looking at sterling adjusted returns, we can see that the strong return of +4.9% from the FTSE USA Index pulled the FTSE All World Index into positive territory. Elsewhere, returns remained mostly negative, but currency strength pushed the FTSE Switzerland Index, +0.7%, and the FTSE Japan Index, +0.1%, marginally into positive territory.

News of the Omicron variant of Covid at the end of the quarter pushed money into what were traditionally believed to be safe havens and bonds moved higher, whilst equities moved lower, although yields were mostly higher, as measured by ten year government benchmark bonds, over the quarter as a whole. The gross redemption yield on the ten year UK gilt ended up 10 basis points higher at 0.81%, on the US Treasury they were 14 basis points higher at 1.45%, on the Japanese Government Bond 3 basis points higher at 0.05%, whilst, on the German Bund, the yield moved the other way by 16 basis points to -0.35%.

In the foreign exchange markets, sterling was generally weaker. Against the US dollar it fell by 3.2%, against the Swiss Franc by 2.8%, against the Canadian dollar by 2.0%, against the Australian dollar by 0.7% and against the yen by 0.3%. On the other hand, sterling rose by 0.8% against a very weak euro.

In the commodity markets, news of the Omicron variant had a significant effect on the oil price which had been very firm. It fell by 4.2% over the quarter. Gold was almost unchanged.

## ECONOMICS

Breaking news in the month of November is that the Oxford English Dictionary has decided to choose the word 'vax' as its word of the year. Its senior editor explains that the word does, in fact, date back to the 1980s but according to their corpus it was rarely used until this year. The word had a supporting cast of extras at the award ceremony, no doubt, including double-vaxxed, unvaxxed and antivaxxer, all helping those who find themselves with both Xs in their Scrabble hand. Given that the word is not new the award would seem to be based on usage and there is little doubt that runners up in this year's award, based on usage, would be 'inflation' or 'transitory'. Who knows what words the business world of economics may offer to the panel in 2022?

In what has been the best signalled policy action for a long time the Federal Reserve has started reversing monetary policy by reducing its purchases of bonds, otherwise known as tapering. Distancing oneself from the white heat of the markets, that would not seem to be a big deal given the consequence of the Fed's involvement in the market over the last few years which has pushed it to the point that it owns around \$5,500 billion of US government bonds as well as \$2,600 billion of mortgage-backed securities. It has been continuing to add to that stockpile at the rate of \$120 billion per month but since November it is now reducing the amount it is adding to its pile, first to \$105 billion per month and then by \$15 billion per month until it is adding no more by the summer of 2022,

though caution applies and the bank asserts that the rate of reduction may be increased or decreased depending on just about anything that may come along. As a proportion of its overall position, the change in tack is pretty insignificant but why market participants are agitated is because it signals the change in the direction of the tide. Many metaphors can apply: markets will be swimming against the current rather than with it, the tailwind has turned into a headwind and until now all boats have risen on a rising tide. The effect at this stage is almost entirely behavioural rather than being a mechanically economic response but markets have been known to move entirely on the spoken word of a significant player in the markets such as Mario Draghi, head of the European Central Bank in 2012, whose words of support caused distressed European debt markets to rally and Ben Bernanke, head of the Federal Reserve in 2013, whose talk of tapering bond purchases caused markets to fall abruptly, though they recovered quickly. Jerome Powell has managed to introduce the very same taper this month without frightening the horses.

There was every expectation that the day after the Federal Reserve announcement the Bank of England was going to do something similar, by tightening monetary policy through a small but significant rise in interest rates. Sterling had risen in anticipation and bond markets had priced in a rise from 0.1% to 0.25%, a small rise from a low level to a still low level in anybody's eyes and there was widespread shock when it was announced that the committee had voted 7 to 2 to keep rates on hold. Bearing in mind the headline rate of inflation was 4.2% against the long held target of 2% it shows some fortitude in their belief that inflation is transitory. The market reaction was notable in that in the four hours trading following the announcement, sterling fell from around \$1.3650 to as low as \$1.3470. Fixed interest markets reacted in a similar way with UK gilts rising in price as the fixed coupon became more attractive relative to cash rates. The yield on the reference 10 year gilt was around 1.03% before midday and fell back to as low as 0.92% later that day. By mid-morning the following day it had fallen further to 0.89%. The Governor of the Bank of England stood by the committee's decision and their forecasts relating to slowing economic growth and the effect on demand-led inflation it will have. Regardless of whether the decision is right or wrong, it is impossible to ignore the volatility created in the foreign exchange and bond markets when they are wrong-footed by such decisions, even when the anticipated rise was never likely to be more than 0.15 percentage points.

Perversely, policymaking for central banks has got a lot harder as the global economy has bounced back in our semi-post-Covid world. The combination of high growth and high inflation invites a tried and tested response from monetary policy committees: tighten monetary conditions, make borrowing less attractive and gently apply the brakes as we accelerate down the hill. The price of money needs to rise. The difficulty of this approach in 2021 is that the scale of borrowing that exists, and the supply of future debt, in an exceedingly expensive market, means that there are significant price sensitivities around those debt instruments and risk around high volatility in what are traditionally lower risk markets, which could make for an uncomfortable ride.

There is, at present, an appearance of debt sustainability for all bond issuers when real interest rates are so low. The flip side of such low yields is high prices and, in common with most asset classes, extreme pricing is associated with high volatility as small factors can provoke a large adjustment. How comfortably markets adjust to higher interest rates, and avoid any rapid fall in prices, will be determined by how much warning is given of rate rises and, of course, the absolute quantum of change.

On 30<sup>th</sup> November the US government could issue 10 year bonds on a gross redemption yield (which factors in regular coupon payments and the capital gain/loss) of 1.5%. With inflation in the month of October running at 6.2%, this means the real rate of interest is -4.7%. Such a rate stretches the bounds of credulity and the only explanation to support the position is that the Federal Reserve Open Market Committee's view that inflation is transitory is correct and that the bond market believes it! The stimulatory effect of such levels of real interest rates must also be considered. A number of economic studies have concluded that a neutral real rate is around 0% and anything below that acts as a stimulus and above that the effect starts to be contractionary. It would seem that with the supply/demand balance so skewed at present, current real rates are deeply unhelpful.

Clearly, the reversal of so many years of loose monetary policy has many consequences outside of our world of investment, but it is worthwhile spending a little time thinking about what effect it could have on the asset classes that we hold and may consider holding.

As policy reverses, with the predictable effect it will have on bonds, is it not unreasonable to think that those not mandated to buy fixed interest securities will reduce the amount they allocate to the asset class. The accompanying level of inflation will have the effect it will on real interest rates therefore it is unlikely that bank deposits will become more attractive in the short term than they are now. Investing in real assets such as property may protect in a time of inflation but will be accompanied with higher funding costs; banks currently reporting are looking forward to improved net interest margin as the market will support a wider gap between the rate charged on lending and the amount paid on saving. If this thinking is correct, all of this is likely to provide some support for equity values where shareholders are buying real assets which should, in the main, be able to pass on the worst effects of inflation, provided extreme, enduring inflation is avoided.

The interaction of the bond and equity capital markets should also be considered in terms of how companies borrow and spend the money they have borrowed. Looking back before the Great Financial Crisis it was the norm that the dividends paid, in percentage terms, to shareholders by companies were lower than the cost of raising funds by selling bonds to the market. This meant that the cost of servicing debt was higher than the cost of rewarding shareholders for the equity capital they had lent the company through the shares they own. A deliberate intention or perhaps an unintended consequence of the reduction of interest rates over the last decade has meant that companies can improve their free cash flow by borrowing money to pay dividends to shareholders. Alternatively, they could borrow money to buy back shares, reducing their future dividend liabilities and improving the share price, all other things being equal, as earnings per share improve as the number of shares decreases. Looking at the S&P500, in the 12 months to March 2021 companies spent \$499.1 billion on share buybacks and this was significantly down on the previous 12 month period to March 2020 when companies bought back \$721.6 billion, presumably reflecting some pandemic caution. The biggest contributor to these figures has been Apple which has bought back \$319.2 billion of its own shares over the past 5 years, though in this case it has been largely funded by profits; its share price has risen fivefold in this period. As interest rates rise, and there is a range of views on how quickly and how far that will go, the attraction of this behaviour will reduce. This is an example of a tailwind turning into a headwind for equities.

The second and more obvious advantage to companies has been the ability to re-finance their debt at a lower cost. Again, free cash flow is improved if a maturing corporate bond paying the holder a 5% coupon (ergo costing the company 5%) is refinanced with a similar bond where the holder receives only 1% per annum. The extent to which companies have benefited goes surprisingly far with a range of highly rated companies having been able to borrow money at a negative overall cost. Corporates have not been able to issue the bonds with a negative coupon, but they have been sold over-par. By this is meant that the bond is issued at, for example £100 with a coupon of 1% and a 2 year maturity. Competition in the market means that the highest bid price for the bond is £104, meaning the company receives £104 on day 1 from investors, pays out £1 each year and repays the investors £100 at maturity. The issuer has been paid to borrow money in actual terms and providing inflation was sufficiently close to zero the company has been, in effect, paid to borrow money in real terms too. Lowering business costs, such as the financing of debt, translates into improved cash flow and stronger net revenue, which will generally be supportive of the share price.

The next area to consider is what effect such low interest rates have had on lower credit-rated companies and what might happen to them in the future. Amazingly, even companies with lower credit ratings, once titled 'junk' but now commonly called 'non-investment grade', have been able to borrow with a negative overall cost. Examples would include ArcelorMittal and Kraft Heinz. These are, naturally, companies that are less able to fund their debt than those at the other extreme, for example, Microsoft and Johnson & Johnson, which are now the only companies with the highest AAA credit rating. Non-investment grade companies are more vulnerable to changes in borrowing

costs as they inevitably have higher levels of debt, an inability to generate significant profits or both. A few steps further down the credit ladder we get to zombie companies that continue to exist because they generate sufficient cash to run their operations and service their debt. They are vulnerable to any change in their revenue or cost base but rising debt costs will, in many cases, sink them. Oddly, there is an economic good in their failing because weaker less efficient producers have remained in the market at the expense of competitors but lack the capital to grow and innovate.

All of the above points relating to bond markets highlight some of the gradual changes which will be evident as a consequence of higher interest rates. The best outcome will depend on a rate of change that is sufficiently gentle that market participants will adapt without causing market wide stress. The worst outcome would be, as in any market, a rush for the exits, causing a collapse in bond prices which would be triggered by a rapid change in perception that dangerously high and persistent inflation will necessitate a rapid acceleration in monetary tightening, particularly rises in interest rates. It remains a concern of ours that bond markets could go through a period of losses that have not been seen for a long period. Collapses in markets perceived as lower risk are more dangerous than collapses that happen in higher risk markets. It is also important to stress that a collapse in bond prices is not our base case but merely a possibility. The reason it should remain a remote possibility is because of the threat it poses to the corporate world. Governments and central banks would move to prevent such a thing happening. On the client side sharp falls in bond markets would impose losses on pension funds, reduce bank solvency and impact insurance reserve asset ratios as bond assets are marked to market. Personal holders would see drops in the value of their portfolios. The irony is that one of the biggest holders of bonds, central banks, some of whom would have contributed to the sell off by absents themselves from the buy side will have to deal with the potential consequences of their actions.

Going back to the start of the current 40 year bond bull run, a term that emerged in the early 1980s was “bond vigilantes”. These were the institutional bond traders who influenced market movements as inflation rose, most notably in 1994. They earned a reputation for being highly sensitive to inflationary pressures and were held responsible for creating volatility and even influencing government spending policy. The genesis of the crisis has some similarities with today in that it was a period of high inflation following the recession of the preceding years. The Federal Reserve raised interest rates from 3% at the beginning of February 1994 to 5.5% by the end of the year after six incremental moves upwards.

Estimates vary but the often quoted figure of a loss of value of \$1.5 trillion demonstrates the shock to the bond market. This is a good example of the speed of change driving the magnitude of the market falls. Indeed, history shows that the higher inflation expectation is, the higher yield volatility will be. Volatility is expensive and introduces uncertainty and for a long time the disciplined and predictable involvement of central banks in bond markets (and also passive investing ETFs) has reduced the volatility of market and contrasts with the ebb and flow of those ‘true’ bond buyers whose constantly changing assessment of issuer risk caused far greater price swings.

It is worth re-stating a point made in last month’s investment memorandum relating to the performance of US Federal debt over the very longest period for which accurate data is available. In the twelve decades since 1900 Treasuries have generated negative returns in six out of the twelve periods, though none of those have been in the last forty years. This is sobering and may well run against the current widely adopted thinking of the attraction of historic bond returns.

When you describe something as a rally it implies a passing phase or a reversal of a downward directional trend but the bond markets have been experiencing a forty year-long rally, however, the tectonic plates under this market are gradually but noticeably shifting, principally due to the largest ‘buy at any price’ buyer in history withdrawing from the market. There are probably three areas of risk in the pricing of bonds and, hence, the return they will generate. Firstly, the imbalance created by false buyers leaving the market will need to be met an equal volume of new buyers. Those buyers may demand a much lower price (and better yield). Secondly, inflation will drive down prices as real returns fall or remain low for increasingly long; higher inflation will, in normal circumstances, lead

to higher interest rates. Thirdly, there is transmission effect. At the highest quality end of the bond market this price adjustment will be around financial losses for bondholders and raised costs for rolling over debt and raising new money. As we go down the credit quality from As to Bs to Cs the risk becomes about affordability which will translate into defaults. We are already seeing this in rising credit default swaps. Zombie companies may meet their day of reckoning.

Readers of this piece must not interpret these views as representing a reduction in the risks of holding equities but, rather, consideration of the re-evaluation of holding bonds; it is worth adding that this is not a change in view but the final months of this year would appear to represent the start of a re-basing of the risk profile. All clients of Meridian will have received a Key Investor Information (KII) document which is carefully designed to highlight, in plain English, the risks associated with holding a portfolio. It follows an industrywide risk scale where a typically constructed Meridian equity portfolio is rated 5 out of 7, or upper medium risk. Bond portfolios, because of their historic performance and limited susceptibility to market crashes are more likely to be rated by their managers as a 3 or possible 4 out of 7. This standardised view has fed demand for bonds and the gains of the last four decades have justified their place as a cornerstone of risk-weighted portfolio construction. If we do continue to see persistent and enduring beyond-target inflation then the risk score of bonds as an asset class may need to be re-assessed.

Whilst the beginning of November started with all eyes on the direction of monetary policy as central banks gradually move (some more than others) from a view of inflation being transitory to being more embedded, the end of month has seen a shift of concern back towards COVID-19 with the emergence of the new Omicron variant. Vaccine failure remains perhaps the largest immediate threat to the world economy because of the difficulties of formulating an effective response and in the evolution of thinking in the two years we have lived with COVID it appears we are being taken in the direction of ‘business as usual’ and even talk of compulsory vaccinations in some countries. Markets have struggled for direction this month as new and inconsistent news on both fronts (virus and monetary policy) has percolated through. This is likely to be the backdrop for markets for some time. We’re no closer to knowing what the 2022 Oxford English Dictionary word of the year will be.

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