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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been another pleasing quarter for international equity investors with satisfactory performances in most markets. Even though sterling strengthened during the quarter, sterling investors' returns were positive. Bond markets were mixed and, in the foreign exchange markets, sterling strengthened against all major currencies. The feature of the commodity markets was a sharp recovery in the oil price.

The tables below detail relevant movements in markets :

International Equities 31.07.17 - 31.10.17

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+4.5	-0.3	+0.4	+1.6
Finland	+0.4	-1.5	-0.8	+0.4
France	+8.3	+6.2	+7.0	+8.3
Germany	+9.0	+6.9	+7.7	+9.0
Hong Kong, China	+3.4	+2.6	+3.4	+4.6
Italy	+5.3	+3.3	+4.1	+5.3
Japan	+10.0	+6.2	+6.9	+8.2
Netherlands	+4.0	+2.0	+2.7	+4.0
Spain	+1.0	-0.9	-0.2	+1.0
Switzerland	+2.8	-1.3	-0.5	+0.7
UK	+2.6	+2.6	+3.4	+4.6
USA	+4.8	+4.0	+4.8	+6.1
All World Europe ex UK	+6.0	+3.4	+4.2	+5.4
All World Asia Pacific ex Japan	+5.6	+3.8	+4.6	+5.9
All World Asia Pacific	+7.3	+4.8	+5.5	+6.8
All World Latin America	+6.9	+1.6	+2.3	+3.6
All World All Emerging Markets	+6.1	+3.8	+4.5	+5.8
All World	+5.4	+3.8	+4.6	+5.9

Source FTSE World Indices

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

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

Currency	31.07.17	31.10.17
Sterling	1.29	1.37
US Dollar	2.30	2.40
Yen	0.08	0.07
Germany (Euro)	0.55	0.37

Sterling's performance during the quarter ending 31.10.17 (%)

Currency	Quarter Ending 31.10.17
US Dollar	+0.6
Canadian Dollar	+3.9
Yen	+3.6
Euro	+2.0
Swiss Franc	+3.7
Australian Dollar	+4.8

Other currency movements during the quarter ending 31.10.17 (%)

Currency	Quarter Ending 31.10.17
US Dollar / Canadian Dollar	+3.3
US Dollar / Yen	+3.0
US Dollar / Euro	+1.4
Swiss Franc / Euro	-1.6
Euro / Yen	+1.5

Significant Commodities (US dollar terms) 31.07.17 - 31.10.17 (%)

Currency	Quarter Ending 31.10.17
Oil	+17.9
Gold	+0.2

MARKETS

It has been another satisfactory quarter for international equity investors. In local currency terms the total return on the FTSE All World Index was +5.4%, in sterling terms +3.8%, in US dollar terms +4.6% and, in euro terms, +5.9%. Looking at individual local currency returns first, the stand out performer was Japan with the FTSE Japan Index returning +10.0%. There were no poor performers but the FTSE UK Index's return of +2.6% was somewhat below that of the FTSE All World Index. However, by any reckoning, its quarterly return was very satisfactory. Looking at sterling adjusted returns, the FTSE Japan Index still performed relatively well with a total return of +6.2%. The UK's underperformance was less pronounced because of sterling's strength and the return on the FTSE UK Index at +2.6% was not significantly below the +3.8% on the FTSE All World Index. There was quite a significant dispersion of performance amongst European markets. In sterling adjusted terms, the FTSE France Index (+6.2%) and the FTSE Germany Index (+6.9%) stand out on the positive side whilst, on the other side, there were negative returns from the FTSE Finland Index (-1.5%), the FTSE Spain Index (-0.9%) and the FTSE Switzerland Index (-1.3%). There was also a negative performance from the FTSE Australia Index (-0.3%).

International bond markets, as measured by the ten year government benchmark bonds, were mixed. The UK government bond's gross redemption yield rose by 8 basis points to 1.37%, whilst that on the US Treasury bond rose by 10 basis points to 2.40%. The gross redemption yield on the ten year Japanese Government bond rose by just 1 basis point to 0.07% but that on the German Bund fell by 18 basis points to 0.37%.

The feature of the foreign exchange market was the strength of sterling. Against the Australian dollar it rose by 4.8%, against the Canadian dollar by 3.9%, against the Swiss Franc by 3.7%, against the yen by 3.6%, against the euro by 2.0% and against the US dollar by 0.6%.

In the commodity markets, OPEC's efforts to raise the oil price had a significant effect with Brent Crude rising by 17.9% over the quarter. Gold was little changed, up just 0.2%.

ECONOMICS

Whilst it is customary for the written and spoken media to dwell on bad news, and this is certainly true in the economic field, it is not surprising that the current good economic news is not receiving the attention which balanced reporting would demand. Yes, there are many political and economic problems but the reality is that the world economy is experiencing a period of synchronised economic growth and the stock markets seem to have realised this judging by the good performance of many equity markets. It is as if we have become so inured to bad news that good news is difficult to comprehend. So, against this background, it is useful to look at the IMF's October 2017 World Economic Outlook with its updated projections. Compared with those for July, it now sees growth in the world economy at 3.6% for 2017 and 3.7% for 2018, both increases of 0.1% over its July projections. Within that figure, it has raised its forecasts for Advanced Economies by 0.2% and 0.1% respectively for 2017 and 2018 to 2.2% and 2.0%. Within the Advanced Economies sector, the projections for the USA have been moved higher, by 0.1% and 0.2% respectively to 2.2% and 2.3%. The projections for the euro area have been raised

by 0.2% for both years to 2.1% and 1.9%. Within that, Germany's projected growth rate has been raised by 0.2% for both years to 2.0% and 1.8% respectively, for France by 0.1% both years to 1.6% and 1.8% respectively, and for Italy by 0.2% and 0.1% to 1.5% and 1.1% respectively. Japan, too, has been given an uplift by 0.2% and 0.1% respectively to 1.5% and 0.7%. The IMF has made no changes to its UK projections of 1.7% and 1.5% respectively. The biggest change amongst the G7 countries has been for Canada with a steep rise of 0.5% this year and a more modest one of 0.2% next year to 3.0% growth this year and 2.1% next year. There has been only a very minor change for Emerging Markets and Developing Economies in 2018 where the forecast has been raised by 0.1%. The forecast for 2017 therefore remains at 4.6% rising to 4.9% next year. However, within that sector forecast, there have been some notable changes. On the downside, the deterioration in the Indian economy has seen its 2017 projection downgraded by 0.5% to 6.7% and its 2018 projection downgraded by 0.3% to 7.4%. China, on the other hand, has seen a minor upgrade for both years of 0.1% to 6.8% and 6.5% respectively. Russia's 2017 projection has been upgraded by 0.4% to 1.8% and by 0.2% to 1.6%. The improved outlook for Brazil is reflected in a 0.4% increase this year to 0.7% and a 0.2% increase next year to 1.5%. Encouragingly, it sees slightly faster growth in world trade volume compared with its July projection, raising the level by 0.2% this year to 4.2% and by 0.1% in 2018 to 4.0%. It has downgraded its inflation projections in Advanced Economies in both years, by 0.2% this year to 1.7% and next year by 0.1%, also to 1.7%. For Emerging Market and Developing Economies, its forecasts have been reduced by 0.3% and 0.2% respectively to 4.2% and 4.4%. All of this is encouraging because, at the micro level, it provides a solid underpinning for company profits and dividends. The political and economic concerns remain the same as they have for many months but have been joined by another one, the increasing pressure by Catalonia for a break with Madrid, which could yet turn very nasty with wider ramifications for the EU. So far, except for Spain, stock markets have been relatively unaffected and the Spanish stock market has reacted on a day by day basis to the latest developments in Catalonia. At the moment, tensions have eased in front of the election in December called by the Spanish Prime Minister, Mr. Rajoy.

Our working assumption is that some sort of accommodation will be reached between Catalonia and Madrid but, if it is not, the implications for the EU and the eurozone could be serious. On the economic front, Spain has recovered well from the financial crisis, although unemployment remains a serious problem. The IMF's projection of Spanish growth of 3.1% this year, and 2.5% next year, is well ahead of what is expected from the eurozone as a whole so, if hostilities broke out as a result of the Catalanian confrontation, those growth rates will be fanciful. The banking sector would suffer and so would Spanish creditworthiness. Whilst the eurozone's growth rate has been accelerating this year, its structural problems have not gone away. Furthermore, as leaders like Mr. Macron want to draw the EU closer together, outbursts of nationalism and threats to break away are damaging to the project which other leaders in the EU are determined to keep together. Events in Spain could cause the eurozone crisis to erupt again and, if this did happen, it would be far more dangerous for the EU than Brexit. For the moment, we are assuming that events in Spain will not completely destabilise the country but it is certainly not a trivial possibility.

Potentially the most serious threat to world peace is North Korea but, again, markets have taken the possibility of a nuclear conflagration in their stride. This may seem a very flippant statement but the truth is that one cannot construct an investment policy based upon the possibility of such a catastrophic event which would change everything, with consequences which we cannot comprehend. One can build an investment policy around expected economic outcomes and, perhaps, political changes which have economic consequences, but not around nuclear war.

Returning to the present, it is remarkable to note the steady uptrend in equity prices accompanied by very low levels of volatility. As we have noted before, this has been a very reluctant bull market with many people not believing its validity. There has certainly been no euphoria. This is good in the sense that we have not seen a speculative bubble, characterised by investors piling into the market and low quality stocks performing spectacularly well with very little fundamental justification. Given that the world economy, as we have noted, is performing moderately well and corporate earnings are rising,

the solid performance of equities this year is rational. We also know that they have performed well because ultra low or negative interest rates have made cash deposits very unappealing, except for ultra cautious investors who are prepared to lose money in real terms, and fixed interest yields are similarly unappealing and bonds risky if bond yields revert to anywhere near the levels we are used to experiencing. In many markets, equity yields are higher than those obtainable on good quality bonds, say ten year government bonds, and, where they are not, as in the USA, they are still relatively attractive in historical terms. In our view, fixed interest securities are a very long way from being realistically valued and if, as we expect, those away from the short end of the market experience significant price falls as yields rise, they will probably never return to the yield levels at which many investors purchased them, thus giving only a very small gross redemption yield if held to redemption, or a loss if sold before maturity. If shares do fall back, history tells us that they are very likely to recover and make a profit if holdings are maintained through the bad times. These very low bond yields are a function of very loose monetary policy of which aggressive quantitative easing is an important component. Paradoxically, the effect which it has had in artificially depressing bond yields has made this traditionally considered “safe” form of investment much less so, not necessarily in qualitative terms but in terms of pure risk of gross redemption yields reverting towards the mean.

Herein lies the challenge for equity and bond markets, which is how well they react to the gradual tightening of monetary policy. Absent events which we cannot foresee, this we rate as the biggest challenge to equities and bonds. Central banks’ balance sheets have expanded dramatically as a result of quantitative easing in the USA, UK, eurozone and Japan. The size of the ECB’s balance sheet is the equivalent of US\$5.1 trillion, that of the Bank of Japan US\$4.6 trillion and that of the Federal Reserve US\$4.4 trillion, together, allowing for roundings, amounting to an astonishing US\$14.2 trillion. It is reasonable to say that the emergency action taken by central banks in the wake of the financial crisis of 2008 did a good job in saving the world economy from very serious recession or depression, but it is not a sustainable policy to keep pumping newly created money into the financial system. Two dangers are clear. Firstly, although it does not seem to be an issue at present, it could set off an inflationary spiral which would be difficult to control. If confidence returns and the money starts circulating more rapidly, inflationary pressures could develop which would be difficult to control. Except in the UK, the worry is lack of inflation, a concern which seems very strange against inflationary problems in many countries not all that long ago. Cheap and electronically created money could cause asset bubbles, the bursting of which could cause serious economic damage. Whilst it is right to place an optimistic spin on the level and consistency of growth which we are now seeing in the world economy, it is also relevant to note that an awful lot of heavy lifting in terms of monetary policy has gone into getting where we are now. It is desirable and important that monetary policy starts to move towards a more normal position whilst accepting that this is likely to be a slow process. Apart from the future threat to inflation mentioned above, there would be little realistic prospect of using monetary policy successfully in the next recession or economic downturn because interest rates could not be cut by much or quantitative easing expanded much more. That is a major concern because monetary policy can be a cost effective tool for regulating economic cycles. It would leave only fiscal policy which, if used, it would weaken countries’ finances. It also severely distorts financial markets for savers and borrowers, forcing savers to move into more risky assets as they chase returns, with all the adverse consequences which this brings if investments turn sour. Borrowers may be led to take excessive risks because of low servicing costs for debt. Companies which would close if interest rates were at normal level on their borrowings might soldier on, crowding out more successful companies with adverse macro economic results. Ten years on from the financial crisis, there is danger that the current profile of monetary policy will seem to be the norm when it certainly should not be.

So, investors face a paradoxical situation. They have very much enjoyed the distortions caused by ultra low interest rates and quantitative easing which have pushed up asset prices but they also realise that it is highly undesirable that ultra loose monetary policy is continued indefinitely because events could then spin out of the control of central banks and governments. The improvement in the world economy, noted in our comments on the IMF’s latest economic projections, gives the chance for most of the central banks to start their policy reversal. In the USA, the Federal Reserve has started to raise interest

rates, in the UK an interest rate hike has just been announced and the mood also seems to be changing at the ECB. Only in Japan is it unlikely that policy will be reversed in the near future. Perhaps the part of monetary policy which is most sensitive for investment markets is the move to reverse quantitative easing and, here, the signalling is most important as markets are unlikely to react well to any shocks. The most aggressive way to reverse quantitative easing is for central banks to offload their bonds on to the market, but it is clear that such a move would be likely to destabilise markets and raise bond yields very suddenly. The more subtle way is that planned by the Federal Reserve which has been reinvesting the payments it receives on its bond and mortgage backed securities portfolio thus keeping a neutral position. The plan now is to cease reinvesting all of the proceeds and gradually raise the amount which it is holding back from reinvestment. Initially, the cap will be set at US\$6 billion a month for US Treasuries and US\$4 billion for agency Mortgage Backed Securities. The caps will be lifted at three month intervals until they peak at US\$30 billion for US Treasuries and US\$20 billion for Mortgage Backed Securities, which is likely to happen in just over a year's time. On paper, this seems to be the most subtle way of starting to reduce the size of the Federal Reserve's balance sheet. In contrast, the ECB has just announced that it is continuing its programme of quantitative easing at €60 billion a month until December and that after reducing it to €30 billion a month until at least September 2018, and leaving its policy flexible after that. Interest rates will remain at a record low until well past the end of quantitative easing. One practical problem with continuing it at the current level, even if the ECB wanted to, is that it could come up against a shortage of eligible bonds to buy as result of the capital key (broadly a eurozone country's GDP in relation to the size of eurozone GDP) and limits on the proportion of any bond issue and amount of a country's debt it can buy. Currently, it is prohibited from holding more than a third of any specific bond issue or more than a third of any country's debt. Germany, which is running a budget surplus, does not need to issue much debt so that constraint could prove to be a problem and that is without a ruling from Germany's Constitutional Court on the eligibility of the asset purchase programme. At the lower 2018 level of purchases, it is believed that the potential problem can be contained. In the UK, the Bank of England's quantitative easing programme was increased to £435 billion post Brexit and it is in a neutral position now, but the first move by the Bank of England to tighten monetary policy will be through an interest rate increase. The G7 central bank least likely to take any action to tighten will be the Bank of Japan as it tries to reach its 2% inflation rate target. In Japan, the size of its central bank's balance sheet is over 90% of GDP, a much larger percentage figure than for the Federal Reserve and the ECB. Because central banks are well aware of the need for careful signalling of their intentions and because monetary tightening will occur for generally good reasons, i.e. recovering economic growth, there is a good chance that equity markets will not take fright. For bonds, monetary tightening will involve higher yields and it remains difficult to make a case for them in this environment.

From a stock market perspective, the challenge for the foreseeable future is how prices will react to a monetary tightening that has been well signalled and, in the case of the USA, done so in a way which would be unlikely to upset markets given the subtle way in which it is planned to be carried out. That then is the general issue for markets, but what about developments in individual countries and regions?

Ignoring the political "noise" in the USA, there are two issues of economic importance, one monetary and the other fiscal. On the monetary side, all eyes are set on President Trump's candidate to be the next Chairman of the Federal Reserve. His view of the present incumbent, Janet Yellen, has appeared negative at times so it is by no means certain that she will be proposed as a candidate for reappointment. He may want to go with someone more hawkish on interest rates, although an early interest rate increase is seen as highly probable in any case. For all the reasons mentioned earlier, it is desirable that US interest rates move towards more normal levels and the USA is leading the way in progressively raising interest rates. The second issue is the fiscal one of tax cuts. Following President Trump's election victory last November, the US market was enthused about the prospect of tax cuts, but nothing has happened in his first year. Now the prospect of corporate and personal tax cuts has been resurrected, perhaps with more chance of success, and US equities are reacting well to the prospect. The President's proposals are just that at the moment, but it is easy to see why investors might welcome them. For business, the plan proposes that the maximum corporate tax rate would be cut from 35%

to 20%. To encourage investment, businesses would be allowed to write off the cost of depreciable assets as an immediate expense rather than over years. Interest expense, on the other hand, would no longer be deductible against tax. Very importantly, the plan proposes a move to a territorial tax system which would mean that tax would not be payable on profits made outside the USA. Vast amounts of cash are currently held overseas by US companies to avoid paying the 35% rate of tax which would be payable if they repatriated funds to the USA. The hope would be that with a lower rate of tax they would bring back the money to the USA for capital investment. If this occurred, companies would no longer be able to offset overseas losses against US profits. For individuals, the plan is to have three tax bands of 12% (currently 10% - 15%), 25% (currently 25% - 28%) and 35% (currently 28% - 39.6%). There may be a higher band for the wealthy. There are other significant changes. Prima facie, these tax reductions are why Wall Street reacted positively to President Trump's election victory last November. Lower corporate tax rates would raise earnings per share for US companies and, therefore, reduce the price/earnings rate of US companies on an unchanged price. If estimates for earnings of the S & P 500 for 2018 before corporate tax cuts are, say, US\$140, analysts estimate that, if the tax cuts go through in the proposed form, then another US\$8 could be added to earnings on the S & P 500. All this is, of course, a big if, but it provides a rationale behind Wall Street's impressive recent performance. Furthermore, although we do not have the full picture for third quarter earnings, and the rise is expected to be more modest than in the first and second quarters because of more difficult comparatives, third quarter S & P earnings growth year on year may be in the order of 4.1% after first and second quarter earnings growth year on year of 15.3% and 12.3% respectively. Earnings growth in the third quarter of 2016 was quite sharply higher than the previous quarter, hence the more difficult comparatives. The expectation is that fourth quarter year on year earnings growth will accelerate again. Encouragingly, revenue growth has been quite strong, helped by the effect of the weakness of the US dollar. Companies cannot rely on cost cutting indefinitely. Dividend growth on the S & P 500 is estimated at the latest quarter end to be running at about 7% higher than over the previous year, thus continuing an unbroken run of growth since the end of 2010 which marked the nadir following the cuts in the financial crisis era. The biggest concern about President Trump's economic policies is his protectionist instincts. Although there has been a lot of rhetoric, there has been only one startling example of a blatantly protectionist act so far which was the imposition of penal duties on Bombardier's C Series single aisle jet following a complaint by Boeing. The US Commerce Department's decision was to recommend tariffs of 300%. This would have shut the aircraft out of the US market, a key one for the success of the aircraft which had secured an order from Delta Air Lines for 75 of the aircraft. It was all the more extraordinary because this was an end of the single aisle jet market in which Boeing does not compete. It may be that the problem will be resolved by the intervention of Airbus to take a majority stake in the project and manufacture the C Series for the US market by assembling it at its Alabama factory, thus turning the tables on Boeing. This episode highlights the danger to the world economy and, by extension, stock markets of protectionism. If a trade war were to develop, the effect on the world economy would be very serious and it would be a very negative development for the stock market. One noteworthy assumption is that wiser counsels will prevail, but developments will need to be monitored carefully. A trade war would clearly be negative for the stock market. In terms of individual items of news, some of the data has been distorted by the devastating hurricanes. For example, the non farm payroll data, which has generally been quite strong this year, was badly distorted in September, with a loss of 33,000 jobs reported against a gain of 169,000 in August. The unemployment rate, however, fell to 4.2%, maintaining the steady fall during the year, but this figure must always be considered in the context of the labor force participation rate, which is quite low in the USA at 63.1% in September. The purchasing managers indices are always closely followed as they are viewed as a good guide to economic activity and the indices for both manufacturing and non manufacturing have been strong. The September manufacturing PMI was 60.8, and that for non manufacturing 59.8, both strong readings and well up from August's levels of 58.8 and 55.3 respectively. Despite all the well known political issues in the USA, the economy is in reasonably good shape. The trend in corporate earnings is encouraging, helping to validate the strength of US shares over the past year.

Moving on to Europe, the most high profile developments have been on the political front with, potentially, the most dangerous developments occurring in Spain. It is difficult to know how this will play out, given the entrenched positions of both sides. For Spain, which has made an impressive economic recovery from its serious problems originating in the financial crisis, although still with very high unemployment, the economic consequences of a secession by wealthy Catalonians would be dreadful. Spain has a high level of debt and there would be issues around the creditworthiness of the country and recurring questions about the banking system, to name but two issues. For the EU, there would be equal concern. At a time of a push towards “more Europe”, a breakaway by Catalonia would be a major problem as it could well encourage more nationalist movements, thus threatening the project. It would be likely to be far more of a problem than Brexit which is, at least, being negotiated, notwithstanding all of the noise surrounding the negotiations. In Spain, it may be a case of both sides backing themselves into a corner from which it is difficult to escape. At the moment, stock markets are not reacting to the potential problems of a breakaway, assuming that some sort of accommodation will be reached. If it is not, the upheaval will be significant in Spain and the EU, sparking further economic and political problems and being a negative for markets.

On the political front, there have been important elections in Germany and Austria, both of which outcomes might be problematical for the EU, perhaps more on the political rather than the economic front, unlike in Spain where the economic consequences of a Catalonian breakaway would be serious for the EU as well as for Spain. In Germany, with the CDU/CSU and SPD parties losing a significant share of the vote in September’s election, the coalition which Mrs Merkel is trying to put together comprising the CDU/CSU (based on their continuing to maintain their historic coalition), the FDP and the Greens, will have to accommodate a wide range of views, which will be difficult. Perhaps most significantly, the FDP, the pro business party, is much more sceptical about the push for “more Europe” which will mean that President Macron’s plans for further integration in the EU will not find the same level of support from Mrs Merkel had she achieved a better election outcome. The loss of the Lower Saxony state election after the federal election has made Mrs Merkel’s task of putting together the “Jamaica coalition” more difficult since she is likely to have to make more concessions to her potential partners having been weakened further by that State’s election result. Germany’s economic position remains very strong, so investors at the moment do not have much to fear from Mrs Merkel’s weakened political position, particularly with the FDP having gained some political leverage, a development that investors are likely to welcome, subject to the trade off which Mrs Merkel has to make with the Greens. A lot of negotiation remains to be done to see if the coalition can be formed. The strong showing of the AfD (Alternative for Germany) also complicates her task for, although none of the other parties in the Bundestag will have anything to do with it, the reasons for its success, mainly immigration, are bound to have some influence on Mrs Merkel. The probable overall outcome of the German election is that further integration within the EU will be slowed and President Macron’s plans for more Europe will hit the buffers, given the new political reality in Germany.

In Austria, where the far right Austrian Freedom Party (FPÖ) performed strongly in the election, it has accepted an invitation from the conservative People’s Party (ÖVP) to enter negotiations to form a new Austrian government. With a strong view on immigration, the new coalition, if it is formed, may give the EU a difficult problem since the FPÖ has been critical of the EU. Again, the Austrian political situation is not likely to influence investors’ attitude towards investing in the eurozone in the short term, but what has happened there, as in Spain, is evidence of nationalist threats to the EU which could spring up elsewhere. Spain, however, could be an investment issue if Catalonia does break away because there would be significant economic implications. At the moment, tensions have eased but certainly not gone away.

On a more positive note, President Macron has not, so far, wavered in his plans to reform the French economy and thereby increase its productive potential. An important by-product of these reforms was the hope that a reformed France would make further integration within the EU more palatable to Mrs Merkel. However, as discussed above, her recent election setback and, in particular, the need to bring the FDP into the proposed coalition with its more eurosceptic approach, may mean that his

more integrationist hopes are dashed. But, from an economic aspect, his more pro business policies, tax reduction and labour market reforms are likely to be beneficial for France and to make it a more attractive country in which to invest. Its highly regulated economy and many French people's antipathy towards business and individual success have influenced attitudes towards investing in France. So far, President Macron has not given way to opposition, as has happened in the past when governments tried to introduce reform measures. Really tough measures, like pension reform, lie ahead and these will almost certainly prove to be a more difficult test for him. So, encouragingly for investors, a start has been made to increase the investment appeal of France, home of many world class companies. However, other of the President's plans are in contradiction to the more business and investor friendly plans outlined above, in particular his protectionist plans for the EU to make it more difficult for non EU companies to acquire EU companies. This protectionist attitude is not good from an economic perspective and sends out a wrong signal. In particular, suspicion of Chinese investment could well rebound on the EU given China's increasing economic importance. Developing corporate champions in a country or regions which are protected from takeovers is not likely to help them to be efficient. Developing the EU as a protectionist bloc carries negative risks for investors over time.

Meanwhile, on the economic front, as we saw earlier in the IMF's updated World Economic Outlook, the eurozone economy is performing quite well. Whilst the latest purchasing managers' indices for October were slightly lower overall than in September, they were still at a satisfactory level. The composite index stood at 55.9 compared with 56.7 the previous month. Within that overall index, manufacturing actually rose to 58.6 from 58.1 but the more important services sector saw a decline to 54.9 from 55.8.

The risk to the European markets are the political ones outlined above and the consequences of monetary policy tightening, when it starts, although that is not just an issue for the eurozone within the larger European context. One can feel reasonably confident that the ECB's signalling will not frighten investors. Early evidence is encouraging. As always, we emphasise that distinction between individual eurozone companies and the eurozone in general. The former can do well even when the eurozone is having problems. Many eurozone companies have substantial overseas interests which can act as a cushion to problems in the eurozone. It remains important to emphasise that there remain fundamental structural problems with the eurozone which could come to light in the next economic recession. No investor should mistake the current calmness within the eurozone for evidence that its structural problems have been solved. They have not. As we have often said in these reviews, the eurozone is not an optimal currency area and this problem may surface when there is a major economic or banking problem in the eurozone.

The UK has particular issues arising from Brexit and a weakened government, following last June's General Election, which is dependent upon the support of the Democratic Unionists for a majority. Because of these issues, the FTSE 100 Index has underperformed most international equity markets, although it is still showing a modest total return for the year to date. These issues are, of course, closely interrelated. Brexit is a very divisive issue, but it is important for investors to assess and understand what is happening so that investment decisions are not driven by an incorrect reading of the situation. From a domestic standpoint, some Remainers are trying to make the negotiations as difficult as they can for the government in the hope that the result of the referendum will be overturned. Other opportunistic politicians are trying to make life as difficult as possible for the government to exploit its weakness. In the EU, in some quarters, there is clearly a wish to punish the UK for voting to leave the UK so that misinformation and disinformation is disseminated and those who are doing this have allies in the UK. None of this is to give a view on the merits or otherwise of Brexit but to state what is happening and why the Brexit negotiations give rise to dramatic news stories in the spoken and written media. It probably does not reflect the reality of negotiations which go on behind closed doors. As well as the uncertainty all this creates, even if progress is being quietly made, there is the issue of the weakness of the government post election. Should the government fall, to be replaced by another with policies beyond the extremity of anything the UK has witnessed, the UK stock market and currency are likely to fall sharply. Again, this is not to pass judgement on any party's particular policies but to point out the

probable reality of the situation. The Shadow Chancellor has indicated that he is gaming the possible sharp fall in the pound should his party move into government. For these reasons, we continue to rate the UK market as one with elevated risk and we continue, except for particular portfolio reasons, to have the bulk of our clients' portfolios invested in overseas markets as an insurance against significant problems in the UK. However, apart from these particular current problems in the UK, it is always, as clients know, our policy to invest internationally to diversify the risk and obtain exposure to attractive opportunities overseas. The returns on internationally diversified portfolios over time have been considerably higher than if one purely invested in the UK, underlining the point.

Whilst Brexit negotiations and the government's current weakened position, at least for the present, might rightly dominate investors' thinking, it is also right to stand back and look at data which, in more normal times, might influence investor thinking about the UK stock market and which should still to some extent.

As we saw from the IMF's World Economic Outlook, it forecasts a slight slippage in economic growth in the UK this year from 1.8% last year, when it was the second best performing economy in the G7, to 1.7% this year which, if the projections are correct, would move it down to fourth but still above France, Italy and Japan. As this is written, the UK's third quarter GDP has been published at 0.4% quarter on quarter, slightly higher than the 0.3% which analysts had forecast. This is the first estimate and might be modified as further data comes in, but it is a moderately positive snapshot of the UK economy. Services and manufacturing contributed to the growth figure but the smaller construction sector was a drag. The significance of this slightly better than expected growth rate is that it removed the last barrier to a 25 basis points rise in UK interest rates to 0.5%, just announced. The relation between the official interest rate, 0.25%, and consumer price inflation, at 3.0%, year on year, is particularly uncomfortable, being far from what would be expected in normal times when the official interest rate might well have been 4% to 5%. Although there has only been a subdued level of pay growth (total earnings rose by 2.2% in the year to August 2017), employment is at a record level and the unemployment rate stands at 4.3%, a level which would normally be consistent with higher interest rates. The drag on the UK economy is that wage growth is lagging behind inflation, thus dragging down consumer purchasing power, although the situation will probably improve next year. The ideal scenario would be wage growth which is supported by productivity growth, at a level above that of inflation, to give a real boost to purchasing power and, through that, to the economy. The lack of productivity growth is a puzzle, but it is not confined to the UK. It is a universal issue, which has perplexed economists and continues to do so. The good news is that the UK has an enviable employment record with record numbers of people in work, but this has not been matched by a similar or greater increase in output. On the other hand, countries like France, which has a better productivity record, have a much worse unemployment situation. All of this provides the Chancellor of the Exchequer with a difficult problem. Although the public borrowing figures have been better than expected so far this year, the UK is borrowing far too much at somewhere around £1 billion a week, so the scope to stimulate the economy through fiscal measures is very limited. On balance, the UK economy is not in a bad position but, as far as the stock market is concerned, the noise around the Brexit negotiations is bound to increase and may unsettle investors, but the political risk is elevated given that political change could lead to policies deeply unsettling for investors. As a result, we believe that investment portfolios, where the mandate allows, should be heavily weighted to overseas markets. This is not only for their attractions in their own right, but also as an insurance policy against unsettling developments in the UK.

In the recent Japanese election, Mr Abe won a striking victory, helped by the disintegration of his opponents. This means that he is likely to push ahead with more determination his "Abenomics" so the taps will be turned on for his economic stimulus. In terms of the relative size of the quantitative easing stimulus in Japan, this has been the most aggressive one if one measures the central bank's balance sheet in relation to GDP. Japan's economic policy has borne fruit in terms of unemployment which stands at just 2.8% against 3.0% at the beginning of the year. But the area in which their targets have not been achieved is inflation. The latest year on year core consumer price index is unchanged, whilst

the consumer price index is just 0.7% higher year on year. For Japan, a modest level of inflation is important in changing the mindset of consumers, long used to falling or stable prices which reduce the incentive to spend money on items which are not an immediate necessity. We may therefore expect a monetary and fiscal stimulus to try to achieve the 2% inflation target and the Bank of Japan may not be uncomfortable if it exceeds that target. Following the election, it may be that investors will feel more comfortable that uncertainty has been reduced and “Abenomics” can continue unhindered. What we should keep at the back of our mind, however, is that Japan has a huge budget deficit, around 4.5% of GDP, and a very high level of outstanding public debt in relation to GDP. The public sector has also built up a substantial position in the stock market through the purchase of exchange traded funds. Whilst all may seem calm at the moment, the potential for trouble later on is clear. In its favour is the fact that the vast majority of public debt is held internally, but there has to be a limit to the size to which the central bank’s balance sheet can expand. It may also be a case of being careful what you wish for. Whilst the central bank is determined to raise inflation to 2%, the seeds are being sown for inflationary problems in later years which may require a reversal of its current policy. That would be very unpleasant for markets. It is not an issue for the foreseeable future but cannot be discounted later on.

In China, President Xi Jinping has cemented his position as the most powerful of the recent heads of state at the Communist Party’s 19th Congress. “Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era” is to be written into the constitution. His plans to increase China’s power and status in world affairs are well known and, from an investment perspective, MSCI’s decision to include an initially modest proportion of Chinese “A” shares in its emerging markets index will mean increasing exposure by foreign investors in the Chinese domestic market. As the weighting in the index of China increases over time, the interest will grow further. The gradual opening up of the “A” share market will be part of a plan to increase China’s importance in the world economy since open markets are essential for this plan to be successful in the long term. At the moment, we are at an early stage of the opening up of the “A” share market with everything being carefully controlled, but there is some movement towards this with the opening, nearly a year ago, of Shenzhen - Hong Kong Connect to follow the earlier opening of Shanghai - Hong Kong Connect. These investment corridors enable foreigners, as part of a two way process, to buy shares in the domestic Chinese “A” share market, subject to daily limits. In terms of the current Chinese economic background, we saw a remarkable comment recently from the Governor of the People’s Bank of China, Zhou Xiaochuan, in which he warned of a Minsky moment, a time when all seems to be going smoothly, only to be upturned by unexpected events, which could cause a sharp fall in asset prices. The relevance to China would probably be the large amount of debt which has been accumulated in the economy. If there was an economic crisis leading to a bursting of an asset price bubble, this would be a Minsky moment. Those who are negative about China cite its very high level of internal indebtedness, which they see as a big risk, and is recognised by the authorities, as they seek to rein back credit. House prices have risen very sharply in some large cities, always a concern from an investor’s point of view. The latest figures show that the average price for new houses in 70 Chinese cities rose by 6.3% in September, down from 8.3% in August, so the authorities are having some success in cooling the market. The slowdown in the rate of increase is due to the action of the authorities in cities where they have introduced tighter measures to control the market.

However, as the strong performance of the Chinese stock market this year shows, the concerns have been outweighed by the positive news. The Chinese economy continues to grow at a steady pace with third quarter year on year growth at 6.8%, only slightly down on the previous quarter’s 6.9%, whilst the quarter on quarter growth rate stood at 1.7%, slightly lower than the previous quarter’s level of 1.8%. With China’s economic power growing, international investors look to China as one piece of the investment jigsaw which will determine their market positioning. For the moment, sentiment is generally positive towards China but it is by no means one way with the bears focusing on debt levels.

Emerging Markets have performed well this year. As we have seen at the beginning of this review, growth is expected to remain well ahead of Advanced Economies, as is to be expected. The weakness of the US dollar has been helpful but, should attitudes to the US dollar become more positive, perhaps because of the expectation of a series of interest rate increases, there is always a danger of outflows from emerging market currencies to the dollar, meaning a tightening of economic policy in those countries with potential effects on economic growth. However, we feel that if the central bank signalling, which we discussed earlier, is managed well then emerging markets shares may not be significantly affected. Something sharp and unexpected on the US interest rate front could be traumatic for these markets, but we think it unlikely. Exposure to emerging markets remains an important part of our investment policy to complement the much larger exposure to developed markets.

Our policy remains unchanged. Equities remain our preferred asset class with a strong emphasis for sterling based investors on international diversification to reduce exposure to the particular risks in the UK which we have outlined. We remain negative on the fixed interest market. As in previous reviews, we continue to emphasise that, after their recent remarkable almost unbroken run, equities must expect to have some quarterly setbacks. As long term investors, we recognise the danger of trying to guess short term market movements and, so, we prefer to concentrate on the longer term, where equities maintain their attractions. Where we have a build up of modest cash levels in client accounts we would look for a reasonable setback in markets, if this occurs, to top up the equity exposure.

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