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ASSET MANAGEMENT (C.I.) LIMITED

# INVESTMENT MEMORANDUM

It has been a negative quarter for equities and a much worse one for bonds as inflation has increased substantially and central banks have pursued much more aggressive monetary policies at a time when economic growth is slowing and a possible recession looms. In the foreign exchange markets, US dollar strength has remained a feature causing problems for many countries. Gold has remained a disappointing investment.

The tables below detail relevant movements in markets :

## International Equities 29.07.22 - 31.10.22

<b>Total Return Performances (%)</b>				
Country	Local Currency	£	US\$	€
Australia	+1.0	-2.2	-7.5	-4.6
Finland	-3.5	-1.2	-6.5	-3.5
France	-3.4	-1.0	-6.4	-3.4
Germany	-3.9	-1.5	-6.8	-3.9
Hong Kong	-24.4	-20.0	-24.4	-22.0
Italy	+1.8	+4.2	-1.4	+1.8
Japan	+0.2	-4.7	-9.9	-7.0
Netherlands	-12.0	-9.8	-14.7	-12.0
Spain	-1.8	+0.6	-4.8	-1.8
Switzerland	-4.3	-3.7	-8.9	-6.0
UK	-3.4	-3.4	-8.6	-5.7
USA	-5.9	-0.5	-5.9	-2.9
All World Europe ex UK	-4.5	-2.9	-8.2	-5.3
All World Asia Pacific ex Japan	-11.8	-10.9	-15.7	-13.0
All World Asia Pacific	-8.0	-8.9	-13.8	-11.0
All World Latin America	+9.2	+14.8	+8.6	+12.1
All World All Emerging Markets	-10.7	-8.2	-13.1	-10.4
All World	-5.6	-2.3	-7.6	-4.6

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -12.4%

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

Currency	29.07.22	31.10.22
Sterling	1.86	3.51
US Dollar	2.65	4.05
Yen	0.17	0.24
Germany (Euro)	0.81	2.14

## Sterling's performance during the quarter ending 31.10.22 (%)

Currency	Quarter Ending 31.10.22
US Dollar	-5.8
Canadian Dollar	+0.2
Yen	+4.5
Euro	-2.6
Swiss Franc	-0.9
Australian Dollar	+2.7

## Other currency movements during the quarter ending 31.10.22 (%)

Currency	Quarter Ending 31.10.22
US Dollar / Canadian Dollar	+6.5
US Dollar / Yen	+11.5
US Dollar / Euro	+3.1
Swiss Franc / Euro	-1.9
Euro / Yen	+8.1

## Significant Commodities (US dollar terms) 29.07.22 - 31.10.22 (%)

Currency	Quarter Ending 31.10.22
Oil	-12.1
Gold	-6.0

## MARKETS

A turbulent geopolitical and economic background led to volatile conditions for international equity markets which ended the quarter lower. In local currency terms, the FTSE All World Index returned -5.6%, in sterling terms -2.3%, in US dollar terms -7.6% and, in euro terms, -4.6%.

Looking at local currency returns first, the stand out performer was the FTSE All World Latin America Index which returned +9.2%. There were also small positive returns from the FTSE Australia Index, +1.0%, the FTSE Japan Index, +0.2%, and, within Europe, from the FTSE Italy Index, +1.8%. On the downside, the FTSE All World Hong Kong Index returned -24.4% in the face of a deteriorating background in the region for investors. Reflecting the regional problems, the FTSE All World Asia Pacific ex Japan Index returned -11.8% and the FTSE All World Asia Pacific Index returned -8.0%. The FTSE All World All Emerging Markets Index returned -10.7%. In sterling terms, the outperformance of the FTSE All World Latin America Index was even stronger, with the index returning +14.8%. The strength of the US dollar meant that the FTSE USA Index ended only slightly lower, -0.5%, meaning that it outperformed the FTSE All World Index.

For the fixed interest market, it was a very poor quarter. Taking 10 year benchmark government bond yields, with the exception of Japan where the Bank of Japan exercises yield control, bond yields rose sharply. In the sterling government bond market, the gross redemption yield rose by 165 basis points to 3.51%, in the US Treasury market by 140 basis points to 4.05%, whilst the yield on the German Bund rose by 133 basis points to 2.14%. These were enormous movements in the context of the fixed interest market, the other side of the equation being the sharp fall in bond prices.

Currency markets were mixed. Against the US dollar, sterling fell by 5.8%, against the euro by 2.6% and against the Swiss Franc by 0.9%. On the other hand, it rose by 4.5% against the yen, by 2.7% against the Australian dollar and by 0.2% against the Canadian dollar.

In the commodity markets, oil, as measured by Brent crude fell by 12.1% and gold continued its poor performance, falling by 6.0%.

## ECONOMICS

By any account, the geopolitical and economic background has been dramatic over the last quarter, yet the overall movements in the international equity markets, whilst mostly negative, do not appear, on the surface, to be anything out of the ordinary. The same cannot be said of the international bond markets.

Investors hate uncertainty and the geopolitical background is so bad that it is hard to know how current problems will end. The stakes in Ukraine seem to rise by the day and US/China tensions are becoming even worse and, even though a Chinese invasion of Taiwan is seen as unlikely, it is a non-trivial possibility. The knock on effects on the world economy are obvious, with Russia weaponising energy supplies, sending inflation to levels which, for many years, have seemed highly improbable and causing governments around the world huge economic headaches.

For economic policy makers, the geopolitical and economic background represents a perfect storm. Central bankers, having largely refrained from tightening monetary policy in 2021, are now having to make up for what many felt was an obvious error at the time in the light of increasing evidence of inflationary pressures. Describing the rise in inflation last year as “transitory” did not seem to accord with the facts then and, of course, certainly does not do now. No one could have foreseen that Russia would invade Ukraine with the resulting economic consequences for inflation. The humanitarian tragedy is the most important outcome of the Russian invasion but the economic consequences for many have been dire. Of course, inflation is much worse as a result of the economic consequences of the invasion, but the lack of central banks’ action in 2021 has made the inflation problem worse. The dilemma for central banks arises from the trade off between the effects of tightening monetary policy and recession/inflation. With economic growth slowing, central banks would normally be thinking of beginning to loosen monetary policy as inflation would be expected to be coming down. Rising interest rates would have been expected to dampen down demand and, therefore, inflationary pressures. But what is occurring at present is a supply shock based on the disruption of the energy markets and the consequent steep rise in the cost of energy and some Covid related supply shortages from China. The supply disruptions arising from Covid caused central banks to describe the rise in inflation as transitory, believing that, when the Covid supply disruption ended, prices of the affected goods would fall back. However, what central bankers fear is inflationary expectations becoming embedded in people’s thinking which, for example, would cause employees to demand much higher pay to compensate for price rises, thus reinforcing inflationary pressures. We are seeing a rise in strikes in the UK and France, for instance, as unions pursue pay deals to keep up with inflation. This is a deeply uncomfortable position for central bankers who are guided by inflation targets, amongst others. The explosion in the inflation numbers has had a profound effect on central bankers’ thinking and they are now tightening monetary policy significantly, notwithstanding the effect this will have on economic activity as they consider inflation to be the greater threat.

As clients will know from these reviews, we have held a deeply negative view of bonds for a long time on the basis that the yields, often negative, bore no relation to reality. Everyone knows that yields were being suppressed by monetary policy as central banks maintained interest rates at very low or negative levels and indulged in quantitative easing (QE), thus causing their balance sheets to grow by very large amounts. The complacency that many experienced, believing that these very low or negative yields could continue, has been well and truly shattered as reality has begun to creep in. So, now, as well as raising interest rates sharply, some, like the USA and UK central banks, are starting to reduce the size of their balance sheets by selling back acquired bonds to the private sector. As well as this additional supply coming on to the market, governments are running large budget deficits as they grapple with current problems, notably energy prices, which are very costly to subsidise. So, the supply situation for bonds does not look good.

Our tables at the beginning of this review show, with the exception of Japan, which is an outlier, the dramatic rise in ten year bond yields (but they could be any maturity), the counterpart of which is a fall in price. For ten year government bonds, the returns for the UK, USA and Germany over the quarter have been -11.8%, -10.2% and -11.0% respectively. This will have shaken the confidence of many investors who regarded bonds as “safe” investments and ones that would moderate the volatility of equities, as advocated by those who favoured the traditional 60:40 equities/bonds model. We have long felt that this is a static model in a changing world which did not catch up with the realities of post Global Financial Crisis (GFC) monetary policy.

James Carville, who was lead strategist for Bill Clinton in his successful 1992 Presidential Election campaign, made the famous quote “... but now (talking in the context of a reincarnation) I would like to come back as the bond market. You can intimidate everybody”. Liz Truss and Kwasi Kwarteng will certainly confirm that this is the case as the bond market finished off their careers, at least at the top level, for now. They were certainly right on one thing, namely that the UK economy has to grow to

provide the tax revenue for the huge outgoings facing the UK government, but, of course, most others as well. The risk was that, because the tax cuts were unfunded, the bond market would not finance the government at an acceptable interest rate and the currency would fall as investors lost confidence in the UK. It turned out that the bond market won that contest and the new Prime Minister and Chancellor are now working on plans to stabilise the UK's public finances which will involve some very tough and, no doubt, unpopular decisions. It is unlikely that the immediate measures to be announced will be helpful for growth. However, a problem facing not only the UK, but many other countries, is that the vast quantities of debt taken on because of the pandemic and now energy price subsidies will gradually and, in some cases, immediately have to be serviced at increasing interest rates, thus adding to governments' budgetary problems. If one looks at the ten year government bond yields at the beginning of this review and compare them with current inflation rates, which are: the UK (10.1%), USA (8.2%) and Germany (10.4%), it can be seen that real yields are deeply negative, not an attractive proposition. The argument in favour of bonds, at their current much higher yields than previously, is that inflation will fall to make the comparison more favourable. Year on year comparisons should take out the sharp increase in prices resulting from the economic consequences of the invasion of Ukraine, but there is no guarantee that prices will not go higher in some areas which will negate the year on year effect. Energy subsidies will have an effect on the inflation rate, but it is unlikely that inflation will drop back to meet current bond yield levels in the short term. There is some uncertainty here, but we do not think there is a case for buying bonds at the moment based on an optimistic forecast for inflation. With such a strong supply of bonds coming on to the market for the reasons mentioned above, it is difficult to be optimistic about the fixed interest markets.

Because of the events in September in the UK, attention focused on the gilt edged market, but the problem exists almost everywhere and the eurozone faces significant problems as well. Monetary union means that spillover effects from one or more members of the eurozone can affect the whole area, as has been seen previously. Italian debt levels are very high with outstanding government debt at over 150% of GDP. For this reason, Italy has to pay significantly more to borrow than the best eurozone credit, Germany, currently about 210 basis points more as measured by ten year government bonds, although it was about 30 basis points more at one stage recently. Whilst the European Central Bank was the most dovish of the major central banks, probably for the very reason mentioned above, it changed its stance in the face of some very unsettling inflation figures. It will be concerned that financing problems in one major eurozone country will destabilise the whole monetary union. Any signs of a less robust stance on monetary policy are likely to add to the euro's weakness, the counterpart of which is the strong US dollar caused by the more aggressive monetary tightening being pursued by the Federal Reserve. Significantly, sterling, so badly affected by the poorly received mini budget in September, has made some recovery once it became clear that policy was changing to address the large fiscal deficit. So, and it's quite logical, the tougher the measures to address inflation and budget deficits, the more a currency responds positively.

However, the very serious economic background and the measures needed to be taken to address the problems mean that it is not a great time to be in government since governments inevitably take some of the blame for what is happening, even though the Covid-19 pandemic and the Russian invasion of Ukraine, with all its dreadful economic consequences, are outside their control.

Prior to the Covid-19 pandemic, we often mentioned in our reviews the importance of politics as well as economics. With the onset of the pandemic and, later, the Russian invasion of Ukraine, economics and particularly monetary policy and its effects on markets has taken centre stage, with politics very much a secondary consideration. We think that this may now be changing. We said earlier that it was not a good time to be in government, with rampant inflation and huge borrowing requirements. In these situations, and with politicians having a shorter time horizon than many investors or companies, the temptation is to go for short term measures which may be electorally appealing but poor economics. Windfall taxes in the energy and financial sectors are on the radar, or have already been introduced, with Europe and the UK leading the way. Whilst the money raised will go towards the cost of measures like the energy price caps, which are extremely expensive, and help to limit the size

of the governments' borrowing, the medium and long term effects are malign. Companies need certainty when they consider investment projects. Sudden changes in tax rates are a discouragement to investment as the potential returns are reduced and, therefore, bad for an economy which needs investment, for example, in the energy sector. Investors will factor such measures into their evaluation of companies and share prices will be depressed below levels they would otherwise have stood at, so raising money can become more expensive. In this scenario, we think the USA scores well. This is being written before the mid term elections on 8<sup>th</sup> November but there is a strong possibility that there will be political deadlock with the legislature, either part or whole, controlled by a different party to the Presidency. Political deadlock can be good for markets because it means investors and companies have more certainty in that nothing significant on the legislative front is likely to happen. So, the calls for windfall taxes, for example, are much less likely to be enacted in the USA than Europe, making it, at least in this respect, a more attractive market. Our strong emphasis on geographical diversification, with the USA at the forefront of our thinking, remains valid in our view.

At this stage of the economic cycle, with high and often rising inflation rates and interest rates heavily negative in real terms but expected to rise further in nominal terms, possibly quite sharply, it would not normally represent a favourable background for equities. Obtaining perhaps a positive real yield on bonds or cash deposits would have made them attractive repositories for cash released from equity sales. However, in the current situation, despite their very poor performance, bonds still seem to us to have significant price risk, whilst cash, as an investment rather than being retained for short term needs or opportunistic purchase opportunities, will also lose money in real terms. Whilst many companies are finding it difficult to absorb significant cost increases, others have been able to pass them on and profitability overall is satisfactory, as are dividend payments, with some companies continuing to increase them. As always, and as witnessed in recent times, reacting to bad news by selling good quality equities can be expensive as they eventually recover and the loss of profit may never be recovered. Even if one is a pessimist, they look to have value against fixed interest securities and cash and, more optimistically, when the news gets better and economic growth recovers, equities should recover. The winter is going to be very tough and it is impossible to make short term forecasts, but the medium and longer term case for a widely diversified equity portfolio remains intact.

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