



meridian
ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

The movements in the world indices shown below do not do justice to the turbulent geopolitical and economic situation. Depending upon the currency of reference, equity prices' movements were not out of the ordinary, but the performance of the fixed interest markets will have unsettled many investors who regarded them as low risk. Currencies were dragged lower, especially sterling, by the strength of the US dollar.

The tables below detail relevant movements in markets:

International Equities 30.06.22 - 30.09.22

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+0.3	+2.0	-6.3	+0.1
Finland	-0.9	+1.0	-7.1	-0.9
France	-2.9	-1.0	-9.0	-2.9
Germany	-7.0	-5.1	-12.8	-7.0
Hong Kong, China	-17.1	-9.8	-17.1	-11.5
Italy	-3.2	-1.3	-9.3	-3.2
Japan	-1.2	+0.9	-7.2	-1.0
Netherlands	-5.1	-3.2	-11.0	-5.1
Spain	-8.5	-6.7	-14.3	-8.5
Switzerland	-4.7	+0.9	-7.3	-1.1
UK	-2.9	-2.9	-10.7	-4.7
USA	-4.8	+3.6	-4.8	+1.6
All World Europe ex UK	-4.7	-2.3	-10.2	-4.1
All World Asia Pacific ex Japan	-8.7	-4.5	-12.2	-6.3
All World Asia Pacific	-6.3	-2.7	-10.6	-4.6
All World Latin America	+6.2	+12.7	+3.6	+10.6
All World All Emerging Markets	-7.7	-2.2	-10.1	-4.1
All World	-4.8	+1.4	-6.8	-0.5

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -12.9%

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

Currency	30.06.22	30.09.22
Sterling	2.23	4.08
US Dollar	3.02	3.83
Yen	0.23	0.23
Germany (Euro)	1.33	2.10

Sterling's performance during the quarter ending 30.09.22 (%)

Currency	Quarter Ending 30.09.22
US Dollar	-8.3
Canadian Dollar	-1.5
Yen	-2.2
Euro	-1.9
Swiss Franc	-5.1
Australian Dollar	-1.1

Other currency movements during the quarter ending 30.09.22 (%)

Currency	Quarter Ending 30.09.22
US Dollar / Canadian Dollar	+7.4
US Dollar / Yen	+6.7
US Dollar / Euro	+6.9
Swiss Franc / Euro	+3.3
Euro / Yen	-0.5

Significant Commodities (US dollar terms) 30.06.22 - 30.09.22 (%)

Currency	Quarter Ending 30.09.22
Oil	-21.8
Gold	-9.0

MARKETS

A turbulent end to the quarter meant that there was little overall change in international equity markets over the quarter, depending on a portfolio's base currency. In local currency terms, the FTSE All World Index returned -4.8%, in sterling terms +1.4%, in US dollar terms -6.8% and, in euro terms, -0.5%. Looking at local currency returns first, the two positive performances came from the FTSE All World Latin America index, +6.2%, and the FTSE Australia Index, +0.3%. Elsewhere, there were underperformances from the FTSE Asia Pacific ex Japan Index, -8.7%, and the FTSE All World Emerging Markets Index, -7.7%. However, the picture changes dramatically when one looks at sterling returns. On the positive side, there were above average returns against the FTSE All World Index from the FTSE All World Latin America Index, +12.7%, the FTSE USA Index, +3.6%, and the FTSE Australia Index, +2.0%. The FTSE Asia Pacific Index remained the worst performer, -4.5%.

The international bond markets experienced a torrid quarter. Taking ten year government bonds as a benchmark, the gross redemption yield on the UK gilt rose by 185 basis points to 4.08%, on the US Treasury bond by 81 basis points to 3.83% and on the German Bund by 77 basis points to 2.10%. Only the Japanese Government Bond saw its yield remain stable, but that was because of the Bank of Japan's policy of yield control whereby it purchased bonds at a level which would maintain its target interest rate.

The feature of the foreign exchange market was the weakness of sterling following the tax cuts in the mini budget and additional borrowing which this entailed, together with the costs of the energy price support measures. Against the US dollar, sterling fell by 8.3%, against the Swiss Franc by 5.1%, against the yen by 2.2%, against the euro by 1.9%, against the Canadian dollar by 1.5% and against the Australian dollar by 1.1%. More realistically, almost all currencies have been affected by the US dollar's strength, sterling more so than most.

In the commodity markets, oil, as measured by Brent crude, fell back by 21.8%, although that was in terms of a strong US dollar, whilst gold remained a disappointing investment, falling by 9.0% over the quarter.

ECONOMICS

September has been a month like no other for these Sceptred Isles with the death of Queen Elizabeth II. Only a small percentage of the population can remember a time when there was a king and those very people will recall a life far removed from what daily life offers today. The shadow of war still darkened the country in 1953, the year of the Coronation, and rationing of meat and other foodstuffs finally ended in 1954. Petrol rationing had ended in 1950. And now, after a more or less uninterrupted improvement in living standards, we have been put on notice that difficult times are coming our way. The Queen embodied many positive and enviable qualities and resilience was certainly one of them. We may be facing a period when this quality is in great demand.

There is an old joke that if you ask three economists for their views on a subject you will get at least four different answers. The economy of the world is the sum of billions of people's contributions and is unimaginably complex, ever-changing and vulnerable to unpredictable yet recurring shocks. Experience of previous pandemics could barely prepare the world for the effects of the last three years and past experience of war cannot insulate the world economy from the terrible conflict in Ukraine. Yet, an early lesson in economics, familiar to all, is that the balance of supply and demand will dictate price. Expressed in a way that could barely be more simplistic, demand since the end of the pandemic has been raised, as accidental savings which had built up have been enjoyed and the supply of goods and services has been limited by shrunken labour markets – the Great Resignation, lockdowns in China and the effects of war in eastern Ukraine, in the first order driving food and energy prices higher. Whilst we are increasingly confident that the COVID-19 virus no longer represents a public health threat, the supply side disruption that it continues to cause (Chengdu, China, a city of 21 million people, went into lockdown on 1st September) prevents industry from returning to maximum production. At the same time, the global supply of cereals, oil and gas and certain industrial metals such as nickel and palladium are affected by the war and the consequential sanctions imposed on Russia. The Second World War was on one hand disastrous for the Soviet Union, losing more of its people than any other country and yet the war facilitated the expansion of its sphere of influence to dominate eastern Europe right up until the start of 1990s. The diminished status of Russia since then has provided the fuel for Vladimir Putin's ambition and it may be more than coincidence that his invasion of Ukraine took place at a time of economic vulnerability.

Whatever his motives, it is clear that the confluence of factors puts the world in a difficult place where a sharp reversal of monetary policy is the unquestionable antidote to the contagious effects of inflation. Different central banks are addressing the threats posed with different policy responses and some of the volatility in markets is down to the uncertainties around future interest rate levels, both the pace of rises and the high water mark. Unfortunately, the inflation reference books do not cover the outturns to be expected after the global events of the past couple of years and market volatility in September has shown that the unpredictability of the evolving position remains. US equity markets fell by two percentage points on 13th September when their measure of inflation for August was reported at 8.3%, which was above the 8.1% predicted by analysts. This was enough to trigger another shift in interest rate futures with the consequential drop in share prices and rise in the value of the US dollar.

To asset managers, bonds and equities have been treated for a long time as complementary products. Asset allocation was, for a great number of years, inclined to a balance, say, of 60% equities and 40% bonds on the premise that each would tend to outperform at different times. The performance of bonds over the last forty years has been flattered by the relentless fall in interest rates. There have been a couple of false dawns, but there can be little doubt that the direction of travel has most definitely changed and countries reducing interest rates are very much the exception; it is a matter of much debate how quickly and how far interest rates will rise. Central banks have taken different stances on interest rate hiking and foreign exchange markets have responded as expected. The dollar has strengthened and measured on a trade weighted basis is now stronger than it has been for 18 years, as cumulative rate rises this year have added three percentage points, rising from 0.25% to 3.25%. The increase in demand for dollars and the reduced supply caused by quantitative tightening (QT) has, of course, a flip side and that is the corresponding 'weakness' it creates in other currencies. Nowhere is this shown to be more true than in emerging markets where much borrowing is done in US dollars as it provides the lender with a greater degree of certainty about what they will get back but, at times like this, it forces the borrowing nation to sell more of its currency or other currencies it holds in its reserves to buy the dollars to service the bonds it has issued. Many of these emerging markets countries have, of course, had to deal with COVID and many are net importers of food and/or energy meaning that, for the first time in a number of years, we are looking at a large number of defaults. September has seen the IMF and China pledge a number of bailouts following the default of Sri Lanka on its national debt for the first time in its seven decade history. The IMF is progressing rescue packages with Pakistan, Sri Lanka, Zambia and Egypt whilst China is promising to forgive some of

the debt owed by seventeen Africa countries, something it has been reluctant to do until now. The sell off in emerging market debt in 2022 has eclipsed the falls in the same markets following the 2008 financial crisis and the average loss, year to date, is about 23%, the worst fall on record for such a period. These are difficult times, particularly for developing nations where inflation rates are higher than in developed countries. The most recent IMF estimates for 2022 are for inflation to average 7.2% for advanced economies and 9.8% for developing economies. Tighter credit conditions for developing countries compound what is already a difficult situation as more government income is diverted to funding existing and new debt. This can be measured by the spread, or extra yield, that is demanded by the market as a risk premium over investment grade sovereign issues. This extra yield premium has increased by over one percentage point since April and now about a third of emerging market borrowers have bonds trading with a yield in excess of 10%. Issuers have been forced to borrow less because of market conditions and issuance is down 40% compared with 2021. The stronger credits have continued to access the market though they have to accept higher interest rates but weaker credits have been shut out.

Moving to the other polar extreme of the credit range we find G20 countries, such as the United States and Germany, considered to be the lowest risks in the market. The interest rate that such countries can borrow at has been artificially suppressed since the Great Financial Crisis by quantitative easing (QE) where credit conditions were deliberately and conspicuously softened to keep the economic wheels turning. Yields are rising in these markets, too, as bondholders demand a greater return given that inflation will eat away at the capital they have lent. As the rise in yield demanded is inversely proportionate to the price of these bonds it's worth considering some examples to illustrate some of the risks of being a bond investor at the present time in a rising interest rate environment. The UK Gilt which matures on 31st January 2032 and is currently the reference 10 year, pays a coupon of 1% per annum and is currently trading at £72.70. It will mature in 10 years, returning £100, so the capital gain along with the annual coupon means it yields around 4.6% per annum. This is in nominal terms and doesn't allow for inflation. If inflation averages 4.6% per annum for the next 10 years then the real return on holding this bond will be around zero. This bond is now trading at £72.90 but at the beginning of this year it was trading at £99.50. A similar bond to this is the 4¼% 7th June 2032 Gilt. As the coupon is higher, the capital gain on the investment must be lower and in this case it is currently priced at £97.70, offering a small capital gain. Again, this will mature at £100 so the 4¼% annual coupon, when adjusted for the capital appreciation, means this bond yields around 4.5%. This bond was trading at around £132 at the beginning of this year. Coming closer to Meridian's home patch, in 2014 the Government of Jersey issued a long dated bond to fund the construction of housing on the island. Its maturity date is in 2054 and borrowers receive a coupon of 3¾% per annum and a payment of £100 in 2054. It is currently trading at £70.20 whereas at the beginning of 2022 it was worth around £147. The bond market is a difficult place to be at present and capital losses such as those in these three examples are reflective of the wider market. All bonds are subject to changing perceptions of credit risk but that would be far less of a factor in this area of the market, compared with non-investment grade bonds such as the emerging markets examples mentioned earlier. The worst potential combination of bond is a long dated, lower coupon, low quality bond denominated in a high inflation currency. The capital depreciation on such a bond has been and is likely to continue to mean a poor investment. The arrival of inflation after such a long absence has played a large role in rendering the bond market a far riskier place than it has been since the 1970s.

It would be easy to think that by buying inflation-linked bonds much of the risk could be eliminated and, to an extent, this is true but the Bloomberg Global Inflation-Linked Bond Index is down around 30% in 2022, performing worse than most other areas of the bond market. To an extent this is misleading because over a longer period they have fulfilled their role in protecting against inflation. The same index over the three years from 2019 to 2021 gained around 25%. The problem in 2022 has been that most linkers are issued with a very long dated maturity, which suits the issuer and also the pension funds and insurance companies that like to match long-dated liabilities with long-dated assets but the price of these bonds has fallen because of the need to reflect the quickly changing interest rate environment.

The most positive point that can be made about bond markets in 2022 is that the depth of correction in pricing has been far greater than in other asset prices. That invites some consideration of whether they now represent a good investment proposition or is it simply that the significant falls in price reflect a market that was distorted by years of easy money and suppressed interest rates to an extent that many commentators and economists ever believed would be possible. In December 2020 there was around \$16 trillion of bonds with a negative yield. By December 2021 that figure had dropped to around \$10 trillion and it now sits at \$1.8 trillion and most of that is in Japan where the Bank of Japan still has yield control measures in place. Just to be clear those bonds represented an investment where the holder was guaranteed to lose money if holding the bond to maturity and that was before making any allowance for inflation. Some examples of the price drops have been given above and represent eye-watering losses for those whose timing was bad. The other side of the coin is that issuers have been able to fund their borrowing requirements at negligible costs and some of the best risks in the corporate market have even found themselves in the position where they were paid to borrow money by investors; Nestlé would be an example. It did happen so we must believe it! The starting point for a new investor in bonds is now much more realistic with the 10 year UK Gilt currently yielding 4.5%, which, if inflation were to settle quickly back down to central bank target levels of 2%, would have some attraction as a risk-free, highly liquid positive real return. The last time gilt yields were at this level was in October 2008, just as the Great Financial Crisis was starting.

The world's bond markets are estimated to be worth around £110 trillion and the rising interest rate environment means that the headwinds bondholders face are stronger than they have been over the last forty years. The largest part of the bond market is institutional investors who have various reasons to buy bonds, such as fulfilling a regulatory requirement or asset and liability matching. There are a smaller number of investors who can buy bonds or equities interchangeably and right now, despite all of the bearish signals from the economy, may see equities as a better option. Meridian has been in this camp for a considerable time and continues to see bonds as trading at inflated prices that, ironically, do not reflect current nor anticipated inflation. These times mark a reversal of what we saw over the previous decade where asset prices, almost without exception, grew at an inflation busting rate. The question is how to best preserve value in times of high inflation and one often referenced piece of research is from financial historians Dimson, Staunton and Marsh who published their findings in a 2002 book 'Triumph of the Optimists: 101 Years of Global Investment Returns', which has since been updated. Their research considered stock market returns, bond market returns, cash rates, inflation levels and exchange rates for 23 countries where there was reliable data for every year between 1901 and 2020, the most recent complete year. The driver was to ascertain how these asset classes performed in varying inflationary conditions and what evidence based conclusions could be drawn. Cash has performed consistently poorly and bonds offered the best returns in times of deflation, such as after the First World War. In all other inflationary circumstances equities outperformed bonds relatively but once inflation reached over 7% neither produced positive real returns. The worst performance combination was bonds in times of high inflation.

Bond markets, such as UK Gilt markets, have been weakened by the surge in inflation, meaning downward price pressure causing bond yields to rise which, in light of the uncertainty around future interest rates, has generated a great deal of volatility in what should be a lower risk asset class. In a busy first month for the new Prime Minister the sensitivities around bond and foreign exchange markets have been seen as various policy decisions and announcements have concerned the markets. Being a net importer of goods and services increasingly over the very long term, this creates downward pressure on the pound as more pounds are sold to fund imports than are bought to pay for exports. In the first quarter of 2022 this current account deficit ballooned to 8.3% of GDP, which was the largest since records began in 1955. The Office for National Statistics advise that there have been some technical changes which have contributed to that figure but the largest contributor is the soaring cost of fuel imports. In theory it is a self-adjusting process whereby a falling pound will make British exports cheaper whilst increasing the cost of foreign assets which, in turn, will bring the current

account back into balance. A primary effect of the weakened currency, though, is an increase in inflation as raw materials and finished goods (and services) cost more in pound terms and supply cannot realistically be substituted by a domestic equivalent. The ability to adapt in the medium to long term is, at the very least, a strength of being in control of one's own currency as its movement relative to others allows for adjustments when confronted with exogenous economic shocks. Being part of a currency union or having a currency that is pegged to another currency are alternatives which greatly diminish the ability to adapt to such market forces. This is a reminder of the events of September 1992 when the pound was locked into a trading band against certain European currencies in the ERM, but was trading weakly and speculators such as George Soros saw the possibility of it being forced out and joined the trade. Despite the Bank of England spending billions of foreign currency reserves in supporting the currency, the pound soon left, devalued and arguably left the UK economy in a better position as it could trade more competitively. Economic theory offers the 'Impossible Trinity' which summarises the difference between then and now. It states that of three policy positions – fixed exchange rate, sovereign monetary policy and free capital flow, it is only possible to have two at any time. The difference between 1992 and 2022 is captured by this hypothesis. The sterling area does, however, have to rely on the "kindness of strangers" as former Bank of England Governor Mark Carney once said. The purchase of UK debt is an important example of such capital inflows and recent weeks have shown how sensitive the markets can be to new news. Going back to the study by Dimson, Staunton and Marsh, a key conclusion is that it is very difficult to invest in a way that provides a hedge against inflation but, rather, it makes sense to invest in a way that protects against inflation in the widest set of circumstances. A glance at any of this year's economic memoranda would leave the reader in no doubt as to our stance on the investment landscape. Central banks' commitment to subduing inflationary pressures through responsive monetary policy has been a feature of the past forty years but war and pestilence have driven inflation up and made the growth or even the preservation of capital far more difficult. These are unfamiliar times but better days will follow. It is a time for resilience.

In terms of investment policy we are therefore still avoiding fixed interest securities as, notwithstanding their marked price weaknesses, we believe they are still offer poor value. An internationally unhedged equity portfolio remains, in our view, the best form of diversification. Whilst fixed interest securities still offer very poor prospects, at some stage the world economy will recover and equities should benefit in the form of higher profits and dividends. The alternatives are unattractive and, although we will continue to see price volatility and negative quarterly, performances, the resumption of economic growth at some stage means equities are likely to recover ground and move ahead again whereas fixed interest securities face significant volatility and structural problems as QE is eventually at least partially removed. It is difficult to see fixed interest securities offering the medium and long term potential of equities given the current level of overpricing.

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