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ASSET MANAGEMENT (C.I.) LIMITED

## INVESTMENT MEMORANDUM

Because of the strength of the currency sterling based investors have seen little movement either way this quarter, although international equity markets remain in positive territory so far this year. Whilst bond yields have fallen over the quarter, noticeable recent weakness in UK government bonds indicates nervousness in front of the new government's budget. There were some quite large movements in the currency markets with the US dollar noticeably weak and the yen strong. Gold continues to perform well as a store of value in uncertain times.

The tables below detail relevant movements in markets :

### International Equities 28.06.24 - 30.09.24

<b>Total Return Performances ( % )</b>				
Country	Local Currency	£	US\$	€
Australia	+7.6	+5.3	+11.8	+7.3
Finland	+3.8	+1.9	+8.1	+3.8
France	+3.4	+1.5	+7.7	+3.4
Germany	+6.3	+4.3	+10.7	+6.3
Hong Kong	+20.2	+13.8	+20.8	+16.0
Italy	+5.0	+3.0	+9.3	+5.0
Japan	-5.0	+0.6	+6.8	+2.6
Netherlands	-7.9	-9.6	-4.1	-7.9
Spain	+9.3	+7.3	+13.9	+9.3
Switzerland	+2.0	+2.4	+8.6	+4.3
UK	+2.4	+2.4	+8.7	+4.4
USA	+6.0	-0.1	+6.0	+1.8
All World Europe ex UK	+1.6	+0.1	+6.2	+2.0
All World Asia Pacific ex Japan	+8.3	+4.6	+10.9	+6.5
All World Asia Pacific	+3.6	+3.2	+9.6	+5.2
All World Latin America	+4.2	-2.3	+3.7	-0.4
All World All Emerging Markets	+9.7	+4.8	+11.2	+6.8
All World	+5.1	+0.8	+6.9	+2.7

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +2.3%

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

Currency	28.06.24	30.09.24
Sterling	4.17	4.00
US Dollar	4.40	3.78
Yen	1.04	0.85
Germany (Euro)	2.49	2.12

## Sterling's performance during the quarter ending 30.09.24 (%)

Currency	Quarter Ending 30.09.24
US Dollar	+5.8
Canadian Dollar	+4.6
Yen	-5.6
Euro	+1.8
Swiss Franc	-0.5
Australian Dollar	+2.0

## Other currency movements during the quarter ending 30.09.24 (%)

Currency	Quarter Ending 30.09.24
US Dollar / Canadian Dollar	-1.3
US Dollar / Yen	-11.0
US Dollar / Euro	-3.9
Swiss Franc / Euro	+2.3
Euro / Yen	-7.4

## Significant Commodities (US dollar terms) 28.06.24 - 30.09.24 (%)

Currency	Quarter Ending 30.09.24
Oil	-15.0
Gold	+14.6

## MARKETS

For sterling based investors, international equity markets showed little change either way, with returns mostly adversely affected by the strength of sterling. In local currency terms, the FTSE All World Index returned +5.1%, in sterling terms +0.8%, in US dollar terms +6.9% and in euro terms +2.7%. Looking at local currency returns firstly, the FTSE Hong Kong Index was the stand out performer after a sharp recovery in the Chinese market following government measures to try to stimulate the economy and assist the property sector. The FTSE All World Emerging Markets Index, +9.7%, and the FTSE Asia Pacific ex Japan Index, +8.3%, were also notable outperformers. The FTSE Australia Index, +7.6%, also performed relatively well. On the negative side, the FTSE Japan Index, -5.0%, was a notable underperformer. With sterling performing strongly, except against the yen and Swiss Franc, sterling adjusted returns were pared back. Where this had most effect was on the FTSE USA Index which in local currency terms returned a very healthy +6.0%, but this fell to -0.1% in sterling terms. On the other hand, a strong performance from the yen meant that the negative local currency return of -5.0% moved into slight positive territory, +0.6%. The return on the FTSE Hong Kong Index reduced to a still very strong +13.8% whilst, despite relative currency weakness, the FTSE Australia Index, +5.3%, the FTSE Asia Pacific ex Japan Index, +4.6%, and the FTSE All World Emerging Markets Index, +4.8%, still showed very good returns.

Fixed interest markets had a good quarter. As measured by 10 year government bond benchmarks, the gross redemption yield on the UK gilt fell by 17 basis points to 4.00%, on the US Treasury bond by 62 basis points to 3.78%, on the Japanese Government Bond by 19 basis points to 0.85% and on the German Bund by 37 basis points to 2.12%.

As mentioned above, sterling experienced a generally strong quarter. Against the US dollar it rose by 5.8%, against the Canadian dollar by 4.6%, against the Australian dollar by 2.0% and against the euro by 1.8%. On the other hand, it fell by 5.6% against the yen and by 0.5% against the Swiss Franc.

In the commodity markets, oil was notably weak, with Brent oil falling by 15.0% on weak demand from China but gold, still proving attractive as a store of value for central banks and private investors, rose by 14.6%.

## ECONOMICS

Whilst overall equity market movements have not been significant this quarter, there has been plenty to exercise the mind of investors and economists. The issues remain significant and the relatively small movement in share prices either way over the quarter belies the magnitude of the issues in question.

On the positive side, we have seen some downward movement in interest rates and so justifying the hopes of stock market bulls who have been counting on this to support their equity and bond positions. Whilst the Bank of Japan is an outlier because it has raised interest rates, its policy has always been idiosyncratic and is not normally a major influence on fixed interest investors, huge though the economy is. The three other significant central banks, the Federal Reserve, the ECB and the Bank of England have all reduced their interest rates in recent times. The Federal Reserve cut its policy rate by 50 basis points to 5.0%, the ECB by 60 basis points to 3.65%, its second reduction, and the Bank of England by 25 basis points to 5.0% in August. In the USA, the inflation rate is down to 2.5%, in

the euro area down to 1.8% and the UK down to 2.2%. So, whilst these inflation levels are not yet all at target levels, around 2%, policy makers have felt comfortable enough with the current inflation levels to start reductions in interest rates. Having been blindsided by the rise in inflation after Covid and not having acted early enough to raise interest rates, they are naturally cautious on the way down as they do not wish to be caught out again. But it is the interest rate trend and expectations that resonate with investors which helps to explain the positive performance of international equity markets so far this year even if there was not much change in the latest quarter in sterling terms.

The OECD has just updated its economic growth forecasts. Overall, the outlook is subdued but the disparity between the USA and elsewhere amongst developed countries remains stark. Looking at the G7 economies, the OECD forecasts the USA to grow by 2.6% this year. The highest growth rates forecast for other G7 economies are 1.1% for Canada, the UK and France whilst Italy is 0.8%, Germany 0.1% and Japan -0.1%. To some extent, these prospects are reflected in countries' relative market performances. Of the major stock markets, the USA has performed best so far this year. Some of this is reflected in the performance of some of the "Magnificent 7" tech stocks but it will also reflect the effect on companies of faster economic growth. The correlation elsewhere is not necessarily a strong one because Germany, where the economic performance has been poor, has performed relatively well although behind the USA. The OECD's forecasts for next year are modest with all of their growth forecasts beginning with a "1". Whilst this level of forecast growth would not in normal circumstances be considered a bullish pointer for equities, provided inflation remains at manageable levels, one would expect the path of interest rates to continue to fall even though residual fears of sticky inflation, for instance in the service industries, may introduce an element of caution into policymakers' thinking. A downward trend in interest rates should help to moderate fears about the high ratings of some equity markers, the USA is a case in point.

Whilst equities remain our preferred asset class, we think it important to concentrate this quarter on issues which may be more difficult to deal with if only to show that equities are not necessarily a one way ticket. Our investment horizon, as clients know, is long term which has the advantage of being able to ride out short term setbacks in markets on the basis that we emphasise in these reviews the dangers of excessive liquidity resulting from hasty decisions to sell shares on bad news (for example, the onset of Covid), only to miss out on any subsequent recovery. This always happens at some stage as long term market trends show, so investors can suffer an irrecoverable opportunity cost. We would have to be extraordinarily alarmed about market prospects to introduce very high percentages of liquidity into our clients' portfolios and that is not the case now. With this important qualification in mind, we want to concentrate on issues which do concern us, namely governments' borrowing levels, politics (in this year of around 40 elections) aggressive regulation and one might say the politics of debt and regulation. All of these will be examined through the eyes of what investors might think and will not involve Meridian giving a view of whether we agree or disagree with governments' policy decisions. It is less subjective to be in the shoes of investors and see what they might think of various policy decisions and how they might react to them.

We want firstly to consider government debt and how this may tie in with the political situation in different countries. The obvious starting place is the USA where we are a month or so away from the Presidential and Congressional elections. Whilst most attention is naturally focused on the race for the White House, investors should be looking hard at what happens in the elections for the House of Representatives and the Senate for they can determine which policies, particularly on taxation from an investor's point of view, a President can get through Congress. For instance, at present with Congress split with the House of Representatives controlled by the Republicans and the Senate by the Democrats, President Biden has not been able to get his tax measures through which would have involved higher corporate and personal taxes for some. Looking at the predictions from pollsters for the US Congressional elections, it is quite possible that the Presidency and Congress will be controlled by different parties although Congress could be split again. What concerns most economists about the USA's economic position is its astronomical level of debt both in relation to outstanding government debt as a percentage of GDP or its budget deficit. The former stands at 122%, a very

seriously high level and its budget deficit as a percentage of GDP is expected to be around 6.9%. Worse still, the non partisan Congressional Budget Office expects this figure to be typical looking ahead as far as one can see meaning that government debt as a percentage of GDP will keep rising. These figures are sustainable until they are not. This may seem a flippant remark but is it not. At some stage, markets will balk at these figures. Neither Presidential candidate wants to talk about this elephant in the room and there is no plan to address the problem. This is not a cyclical deficit. It is a structural one. Those who are relaxed about the level of US government debt tend to relate their view to the fact that the US dollar is the world's largest reserve currency and is therefore immune to market pressures believing that investors will always swallow up ever larger amounts of US government debt. But sceptical investors, if they are being asked to buy more US Treasury bonds, will eventually want higher interest rates to compensate for this. Higher funding costs will weigh on the US budget, threatening to make the US budget deficit even larger because of the servicing costs and so we get into a vicious circle. The USA may have more protection than other countries because of the unique status of the US dollar but it is not immune from market pressures. We will come on to France shortly but we can already see from the eurozone government bond market that its very serious debt problem is not going unnoticed by bond investors. France's ten year government bond is now yielding more than Portugal's and Spain's whilst the spread over the German Bund is now about 80 basis points.

From the extent of the USA's debt problem to the forthcoming Presidential and Congressional elections is a small step. Neither of the two Presidential candidates seem to want to talk about the deficit for fear of upsetting the voters. Either of, or a combination of, the solutions, tax rises on a broad scale or expenditure cuts must be deemed vote losers. Where we do have some visibility on the two candidates' policies, investors will have good reason to be concerned or sceptical or both. Just before we go on to this, because it is relevant, is the messaging politicians give out about their country. Is it positive so that one wants to invest in it either through the stock market or as a direct investor into a business or is it a message which suggests it is a market or country best avoided? Now back to the two candidates where investors will probably find the messaging gives out negative signals. For Kamala Harris's economic and tax policies the micro economic measures suggested will be regarded as almost certainly negative. For companies, the plan is to raise the company tax rate from 21% to 28%. That would obviously reduce earnings per share below what they would otherwise have been with potential effects for dividends. For individuals, the proposals might be considered even more unpalatable. Apart from higher taxes on the wealthy both in the form of income and capital gains, she has plans to tax their unrealised capital gains which would send out an extraordinarily bad message about the country being a place to invest in. Investors will regard this messaging as highly negative and we do not know of another country which would seek to tax unrealised gains. So, whilst the micro details of Kamala Harris's plans might be unwelcome for investors so the macro ones from Donald Trump may also be. Undoubtedly on tax, his message will be well received by investors, namely his plans to extend all tax cuts he got passed by Congress in 2017. He also wants to cut corporate taxes again. However, on the macro side, import tariffs would give a negative message for they could push up inflation if the US dollar doesn't adjust upwards and higher inflation would make the Federal Reserve's position in terms of plans they may have had to cut interest rates more difficult. If tariff increases led to retaliation then the world economy would be likely to slow down and go into recession. Except in specific circumstances, general import tariffs are highly undesirable.

So, if the messages which the two candidates are giving out is negative what might investors see as affecting arguments for investing in the USA? It's back to our earlier point about the forthcoming Congressional elections. Looking at the forecasts at the end of September suggests a good chance of split legislative and executive results. Sometimes, a position of stalemate can be good because the status quo, and therefore some certainty, remains. However, the main economic worry for investors is the level of borrowing which is seemingly out of control and with no sense of urgency to attack the problem being shown by either of the candidates.

If the debt problem is bad in the USA, it could actually be worse in the eurozone in the shorter term by virtue of monetary union. In the worst case, the USA could print money, reversing Quantitative Tightening and going back to Quantitative Easing. That would have serious disadvantages, but it could be done at the risk of debasing the currency and few economists would recommend this as a course of action to deal with the USA's borrowing problem. But, for the eurozone, the problem is worse. If a country's borrowing profile causes investor concerns or makes it difficult to fund its own borrowing requirements, it cannot do what the Federal Reserve or Bank of England can do, i.e. print money or set an independent interest rate. Its problems cannot be contained to one country alone. So, if France found itself in difficulties, other countries would not be immune because its problems could affect the euro. The particular problems of France make this a relevant topic for discussion. Because it does not have a stable government following the inconclusive legislative elections called by President Macron after the RN's strong showing in the European Parliament elections, it is not in a strong position to tackle its budget deficit problem. The deficit this year is forecast to be around 5.9% of GDP, well over the EU's allowable limit of 3%, and still far too high for a country whose government debt to GDP ratio is around 111%. The particular issue with France is that it is almost impossible to tackle the high level of government spending without igniting social unrest, yet raising taxes is difficult because it is already a very highly taxed country. The government has hinted at higher taxes on the wealthy and large companies but, in terms of messaging, which we have just talked about, investors would regard such measures negatively. Were the parties on the extremes to have their wish of reducing the retirement age with the consequences for public spending, the situation would become even more serious, almost certainly causing big problems for the French debt market. As well as negative relative movements in the government bond market, the performance of the French stock market has also been relatively weak, so, from both the bond and equity markets, we do have evidence this year that politics (the inconclusive parliamentary election result) and messaging (perhaps higher taxes on the wealthy and large companies) are relevant for investors in making their country asset allocation decisions.

In this year of elections, we have, in previous reviews, mentioned examples where the results mean that politics and messaging do matter and have been reflected in market movements. It is worth considering briefly two such elections. The South African election meant that the ANC lost its majority in parliament, which, after much negotiating, led to some of the minority parties coming into government with the ANC, crucially including the business friendly Democratic Alliance (DA). Given the very weak state of the South African economy, investors took heart from the result, gaining a measure of confidence that meaningful measures will be taken to address the country's serious economic problems. But the opposite is true in Mexico, where the left wing President, known as Amlo, is to be succeeded by his protégé, Claudia Sheinbaum, who is likely to follow very much the same policies. With super majorities in the Senate and Chamber of Deputies, the constitution can be changed. One of the measures which is causing significant concerns is the sacking of judges and the introduction of voting for members of the judiciary, meaning that the judiciary will be politicised or at least appear to be. Amongst those who will fear the uncertainty will be businesses who would normally rely on the courts to interpret disputes objectively and to uphold the rule of law. For most of his time in office, Amlo, despite his anti business rhetoric and actions, followed a conservative fiscal policy, limiting the size of the budget deficit but, in the run up to the election, he allowed this discipline to lapse with the result that the budget deficit is expected to be around 5% of GDP this year. The currency has reflected investors' fears. In their contrasting ways, these two countries' markets reaction to election results and the possible consequences show the importance of politics and the messages which are sent out to markets.

Whilst the US elections will be the most important ones this year, we have, of course, recently had the UK general election. Whilst we have some ideas about the new government's plans, for investors the 30<sup>th</sup> October budget will give the main signals. However, some early actions and messages are relevant and again we make the point that this does not reflect any Meridian views of whether we think they are right or wrong (that is not our job), rather we are concentrating on the conclusions which investors might draw from them. As a general issue, the Prime Minister and Chancellor of the

Exchequer, certainly until very recently, went out of their way to emphasise what they said was the appalling legacy which they had been left with and making it clear that what they saw as “black holes” in the public finances would have to be dealt with in a painful budget which would fall on those with broad shoulders. It is not controversial to say that this does nothing to bolster business confidence and, according to the Institute of Directors’ economic confidence index, business confidence has sunk to its lowest level since December 2022. There is speculation about the motives for their downbeat pronouncements, but this is a clear example of why messaging is important for investors, whether they be for direct investment or stock market investment. We can, however, pick out various actions which investors are likely to take as negative ones. The previous government put windfall taxes on North Sea energy producers and the new government is making these more severe. The point here is that arbitrary and capricious taxation, targeted at specific sectors, sends out a negative message about the investment attractions of a country. Allied to this message was the government’s decision not to fight a legal challenge from Greenpeace and Uplift against the decision to grant consent to drill untapped oil and gas fields, called Rosebank and Jackdaw. Of course, this is a controversial subject, but for the government not to defend a challenge against a previous consent is a negative message suggesting that it does not care about the offshore oil and gas industry. By way of example of the possible effects of the government’s action the TotalEnergies CEO said at the beginning of October that the company will curb its investment in the UK and restructure its operations in the North Sea if the government increases a windfall tax. Another message comes in the form of making more restrictive the previous government’s moves to tighten the non-dom regime in the UK. The message this sends out is not a good one as it implies that wealthy people and successful people are not welcome in the UK. Given that such people might well invest in the UK, investors will not see this as a positive move by the UK. On the other hand, giving a more positive message, was the decision to allow an increase in passenger numbers at London City Airport despite opposition from the local council. This may seem a relatively minor matter but it isn’t because it can be taken as a sign that the UK is open for business, with airport capacity restrictions in a number of countries restricting competitiveness. We will know more after the 30<sup>th</sup> October but, given the effect of the message of economic gloom on business confidence, investors may be forgiven for seeing this as something of an own goal. The UK’s position, in many respects, can be compared relatively favourably, say, with that of France and Germany, and it is interesting to see that the UK has received the biggest annual growth upgrade in the G7. Granted, the upgrade for this year is only to 1.1%, but it was a 0.7% upgrade on the OECD’s May forecast. So far, it is fair to say, investors’ and businesses’ confidence in the UK will not have been increased so the October 30<sup>th</sup> budget will be a crucial pointer to the attractiveness or otherwise of investing in the UK. The kindness of strangers will be tested in gilt markets as demand from pension funds for long dated assets and QT increases reliance on overseas buyers.

Whilst political messaging is an important signal for investors, we have been emphasising in recent reviews the role of regulators as they may affect stock markets and, often, they have a connection with politics in the relevant country or region. We have noted the increasingly aggressive actions of regulators in the USA, UK and Europe, sometimes moving into areas which are hard to fathom. The main, but not only, targets have been the technology companies, whether in the realms of acquisitions or perceived market dominance in their existing businesses. AI is actively engaging regulators’ minds at present. It is hard not to see a political aspect in some of the regulators’ activities. But whether regulators are right or wrong, their seeming crusade against tech companies does have wider market implications. At the stock market level, the amount of uncertainty introduced may affect valuations. At the direct investor level, it may make entrepreneurs less inclined to invest in existing young businesses or even start up businesses. The reason is that many of these companies are often sold to larger businesses and that is their exit route. If that can be blocked by regulators on hard to understand grounds they may be less inclined to invest. Regulation creep, although on the rise, did suffer a significant setback in September when the Court of Justice of the European Union put an end to controversial efforts by the European Commission to extend its merger control jurisdiction. Since 2021, the EC has claimed a right to review deals that meet no filing thresholds anywhere in the EU. This made it difficult for the deal parties to know if their deals might be reviewed by the EC. The



proposed deal in question was an acquisition by Illumina, a US company specialising in genetic sequencing, of GRAIC, a US firm developing cancer detection technologies. Interestingly, Mario Draghi, the former Head of the ECB and Italy's ex Prime Minister, produced a report which describes a cycle of "low industrial dynamism, low innovation, low investment and low productivity growth" across the EU. Importantly, it includes a chapter on competition enforcement's trade off against competitiveness, meaning that, because the EU is uncompetitive in many areas, greater industry concentration may be necessary if Europe is to compete. At present, in general, regulators appear to be too narrow in their focus without looking at the wider picture. These issues are relevant for direct and indirect investors in different countries and, we believe, at present send out negative messages. As this is written, the Department of Justice has indicated that it was weighing up a possible breakup of Google as an anti trust remedy. Google will be likely to appeal any remedies and the process will be likely to go on for many years. But investors will not welcome the aggression and perhaps politicisation of regulation on the grounds that uncertainty will affect the attraction of investing directly or indirectly in a country.

Returning now to immediate events around us, as this is being written, the already unsettled situation in the Middle East has become more so following Iran's missile attack on Israel. Without being complacent or callous, in the light of appalling human suffering in so many places, markets have stayed remarkably calm, perhaps because investors have become resigned to this permanent state of unsettled affairs. But it goes without saying that the situation in the Middle East and Ukraine is extraordinarily unstable. However, that does not mean that one should move to a highly defensive liquid position. The long term performance of international equity markets tells us that this would be unwise given the dangers of being caught with excess liquidity when markets recover. Bonds might be considered a good balancing option to equities but, as we have tried to explain, so bad is the position of so many countries' finances and the resulting large supply of new bonds to finance these budget deficits, plus increased creditworthiness risks, that we do not consider the prospect of falling interest rates to be a reason to gain exposure when this trend might be stopped in their path by concerns about countries' level of borrowing. We mentioned the effect of the unstable political situation in France and the effect which this has had on French government bonds. We might also note significant recent weakness in the UK government bond market as uncertainty grows about how the new government will square its pre election pledges on taxation with its spending plans and whether the goalposts for defining borrowing might be moved as some economists have suggested.

This review has largely been about politics and messaging. In deciding the geographical asset allocation to follow, one should be largely guided by how attractive the investment environment is, meaning that the factors we have discussed in this review should be taken into account as well as the economic context and future economic prospects as they affect companies. There are a lot of conflicting currents at present in markets and major uncertainties including the forthcoming US election so market progress may be uneven in the near future. As ever, international diversification remains of paramount importance, particularly so for sterling based investors when risks have possibly become more elevated in the UK.

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