meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Equities showed a satisfactory return in the latest quarter, strongly influenced by the performance of Wall Street. This performance was in contrast to the movement in bonds which was negative. In the foreign exchange markets, the moves were relatively modest apart from the significant weakness in the Yen. In the commodity markets, the strength of oil was a notable feature as OPEC+ put their supply reductions into practice.

The tables below detail relevant movements in markets:

International Equities 31.05.23 - 31.08.23

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+4.5	+2.3	+4.6	+2.7
Finland	+0.1	-0.3	+1.9	+0.1
France	+3.0	+2.6	+4.9	+3.0
Germany	+1.8	+1.3	+3.6	+1.8
Hong Kong	-1.2	-3.6	-1.4	-3.2
Italy	+11.5	+11.0	+13.5	+11.5
Japan	+9.4	+2.7	+5.0	+3.1
Netherlands	-4.1	-4.5	-2.3	-4.1
Spain	+6.2	+5.7	+8.1	+6.2
Switzerland	-0.9	+0.3	+2.6	+0.7
UK	+1.3	+1.3	+3.6	+1.7
USA	+8.4	+6.0	+8.4	+6.5
All World Europe ex UK	+2.5	+2.0	+4.2	+2.4
All World Asia Pacific ex Japan	+3.5	+0.7	+2.9	+1.1
All World Asia Pacific	+5.5	+1.4	+3.6	+1.8
All World Latin America	+5.6	+7.0	+9.4	+7.4
All World All Emerging Markets	+5.2	+2.4	+4.7	+2.8
All World	+6.6	+4.3	+6.7	+4.8

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -0.1%

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

Currency	31.05.23	31.08.23
Sterling	4.18	4.36
US Dollar	3.65	4.11
Yen	0.43	0.65
Germany (Euro)	2.28	2.46

Sterling's performance during the quarter ending 31.08.23 (%)

Currency	Quarter Ending 31.08.23
US Dollar	+1.9
Canadian Dollar	+1.4
Yen	+6.5
Euro	+0.4
Swiss Franc	-1.1
Australian Dollar	+2.2

Other currency movements during the quarter ending 31.08.23 (%)

Currency	Quarter Ending 31.08.23
US Dollar / Canadian Dollar	-0.4
US Dollar / Yen	+4.1
US Dollar / Euro	-1.9
Swiss Franc / Euro	+1.6
Euro / Yen	+6.1

Significant Commodities (US dollar terms) 31.05.23 - 31.08.23 (%)

Currency	Quarter Ending 31.08.23
Oil	+15.8
Gold	-1.1

MARKETS

It has been a satisfactory quarter for international equity markets, with the majority of international equity indices advancing with the USA leading the way. In local currency terms, the FTSE All World Index showed a total return of +6.6%, in sterling terms +4.3%, in US dollar terms +6.7% and in euro terms +4.8%. Looking at individual markets first in local currency terms, the outstanding market was the USA where the FTSE USA Index returned +8.4%. There was also an above average performance from Japan where the FTSE Japan Index returned +9.4%. On the other hand, the FTSE UK Index, +1.3%, and the FTSE All World Europe ex UK Index, +2.5%, were notable underperformers although still showing a positive result. Turning now to sterling adjusted returns, some modification to the picture emerges. Whilst the FTSE USA Index still shows an above average return, +6.0%, it is joined by the FTSE All World Latin American Index, +7.0%. On the other hand, the FTSE Japan Index, +2.7%, moved to a below average performance.

Bond markets did not enjoy as solid a performance as international equities. Taking 10 year government benchmark bond yields, the gross redemption yield on the UK gilt rose by 18 basis points to 4.36%, on the US Treasury Bond by 46 basis points to 4.11%, on the Japanese Government Bond by 22 basis points to 0.65% and on the German Bund by 18 basis points to 2.46%.

In the foreign exchange markets, the best performer on our list was the Swiss Franc followed by sterling. Against the Swiss Franc, sterling fell by 1.1% but against a continuing weak yen it rose by 6.5%, against the Australian dollar by 2.2%, against the US dollar by 1.9%, against the Canadian dollar by 1.4% and against the euro by 0.4%.

In the commodity markets, moves by OPEC+ to restrict oil supplies to boost the oil price are starting to show results and, over the quarter, oil, as measured by Brent Crude, rose by 15.8%. Gold was little changed, down just fractionally in price.

ECONOMICS

Sometimes language is not immediately easy to digest. A good example of simple language that carries a more involved definition is when the term ‘interest rate’ is referred to as the price of money. This is confusing, possibly because we think of money as the measure of price but an interest rate is explained to us by those who know as the price of money. This definition may seem hard to apply in the context of everyday purchases of goods and services but perhaps considering other practical uses of money helps and two circumstances spring to mind. Those who have money and no call on it will deposit it with a bank and in doing so will provide a short term loan to the bank which the bank will treat as a liability and pay a rate of interest on the deposit (hopefully). Others, such as house buyers, will pay interest on a mortgage in exchange for the lump sum up front. In the former example the bank is renting the depositor’s money and, in the latter, it is being paid to lend out its own. The bank sets its own prices and a bank’s ability to retain money by gathering deposits and reducing lending through interest rate pricing, or doing the opposite, is a vital and very current economic factor.

Awareness of interest rates is, arguably, higher than it has been for a considerable time for two reasons. Firstly, because of the decade or so when they were suppressed at record low levels and, secondly, it is difficult to find another period in history where interest rates have risen so precipitously. The decade or so of near zero interest rates was the consequence of an unimaginable global event, the Great Financial Crisis, which provided an unnatural starting point and then two more unimaginable global events, COVID and the war in Ukraine, have, in different ways, introduced inflation and fuelled the need for ever higher interest rates. In the United Kingdom the annual cost of borrowing £100,000 has risen by somewhere around £5,000 per annum as interest rates have been lifted from 0.1% at the start of December 2021 to their current level of 5.25%, reached on 3rd August 2023. Recent figures, however, from the Bank of England suggest that these rises are, at present, contributing to the economy rather than damaging it. Bloomberg analysis of the data suggests that households are, in aggregate, better off by around £10 billion per annum due to the jump in interest rates. At current interest rates, savers are earning £24 billion more than in November 2021, when rates were at their floor and mortgage borrowers are paying £14 billion more in debt interest. There are a great number more savers than mortgage borrowers. The balance continues to change as there is the protective lag around fixed rate mortgages and around 85% of borrowers have chosen to fix, but 1.5 million of those deals are due to roll off in 2024 and will refix at significantly higher levels.

Having used the word “interest” twelve times in the first two paragraphs of the memorandum but “inflation” only once, moving on to the subject of inflation seems apt. Data continues to reach the markets and figures in August have shown that UK inflation was still well above target in July at a headline rate of 6.8%, over three times higher than the Bank of England’s target rate of 2% but well down from the recent peak of 11.1% in October 2022. The mortgage example given above points to a major lag in the transmission of higher interest rates to lower inflation and commercial decisions to invest in businesses. The increased cost of refinancing corporate borrowing and the drop in consumption are all shaped by higher interest rates but it takes time for the economic effect to feed in to the economy’s inflation rate.

This memorandum has highlighted in the past that the monetary policy adopted by the world’s central banks following the financial crisis of 2008/09 was unprecedented yet remarkably uncontroversial given such unanimity on the need to stimulate and support the fragile world economy of the day. It was, all the same, an economic experiment. The appreciation in asset prices and the increase in indebtedness that accompanied the policy are both now in focus as the price of money has risen and at the epicentre of this has been the world’s bond markets.

As the price of money has risen, the price of bonds has fallen because of the inverse relationship between the yields on bonds and their market value. If a bond valued at £100 yielding 4% per annum through its £4 annual coupon falls in value to £50 then a buyer at the new price level still enjoys the £4 per year but is now getting an 8% current yield on the £50 invested. A bond price that we reference, for self-evident reasons, is the Jersey Government Bond maturing in 2054 with a coupon of 3.75%. As background interest rates first fell and then have risen the price has moved to reflect market interest levels. The bond was issued in 2014 at just below £100 and therefore yielded 3.90%. When interest rates reached their lowest point in December 2021 the bond had risen in value to £164 which at that point represented a significant paper return for bond holders from day 1. The bond price has fallen abruptly since then and at the time of writing its value was £75. This is a minor sovereign issue which has a credit rating of AA-, so not far off the highest level, but it is not difficult to see that such bonds have not behaved as a lower risk, high quality bond should, or, more accurately, how reasonable investors in the bond expected it to behave. This is an important point because the risks around holding cash and owning bonds are not as immediately obvious as holding equities. The ‘advantage’ of equity investing, if it can be put that obliquely, is that the pitfalls – periodic price volatility where markets fall sharply - are known. Volatility in higher risk markets is less jarring than equal volatility in lower risk markets, such as fixed income bonds. Last year was a bad year for bonds and, a recommended read, the Credit Suisse Global Investment Returns Yearbook, states that global bonds lost 31% in

2022, the worst annual performance for fixed income in data stretching back to 1900 with UK bonds performing even worse, returning minus 39%. Bonds perform well when interest rates fall and badly when interest rates rise and the Yearbook concludes that 2022 marked the end of a four decade long "golden age" for the bond market and that it is unlikely to be repeated. Four decades represents many professionals' careers and many in the investment management industry had not, until 2021, experienced life outside of this long bond bull market but the Credit Suisse Yearbook provides data that adds context to this long recent period of outperformance. Summarising their 54 pages of academic research into one data set risks sacrificing some detail but their calculations, over 122 years from 1900 and adjusted for inflation, show UK equities returning 5.3% per annum, bonds returning 1.4% per annum and bills (akin to cash) 0.9% per annum. The equivalent returns for the US market are equities 6.4%, bonds 1.7% and bills 0.4%.

The 14 interest rate rises of the last 18 months have been helpful for those who remain in cash but the rate rises have been in response to much higher inflation, meaning the return on cash, after adjusting for inflation, is little or no better than when both metrics were closer to zero. Where mandates allow, our portfolios remain very much equity focused and for those investors who have the luxury of a medium to long term investment horizon we continue to believe that their appeal remains higher than that of bonds or cash. Finding a perfect investment hedge for short term inflation is, in reality, extremely difficult so focus should remain on being in an asset class that has performed well over the long term in inflation adjusted terms. The suppliers of goods and services that constitute the Consumer Price Index represent, in some ways, a hedge against inflation because share price performance should reflect the ability of companies to raise their prices in these times and maintain and grow sales volume.

By virtue of the large downward shift in bond prices over the last eighteen months the market has become more attractive, relatively, and of all leading asset classes it would be the one which experienced the largest price adjustment. At the time of writing, the benchmark 10 year UK Gilt is showing a gross redemption yield of 4.46% so holding to maturity would provide that level as a nominal return. There is then the question of what the real terms value of the bond would be in 2033 which makes the quality of the investment highly contingent on future inflation levels. High future inflation will invite ever higher interest rates, depressing both the price of the bond and the real value of the return of capital at term, whilst low inflation will present the opportunity to sell out early and make a capital gain as the bond's price rises to reflect lower interest rates in the market. The attractiveness of this depends very much on the future direction of inflation which, needless to say, introduces an element of the unknown. Higher yields are available at lower credit levels but the risks around inflation pervade all areas of the market.

Adding to the interest rate risk introduced by the uncertainty around inflation is the issue of supply and demand. Bond markets differ from equity markets in that the supply of bonds to the market is subject to significant change, particularly in the last few years. Shares in a company are usually issued at the point of a public offering and will change owners many times but are permanent capital. The share count might be diluted by a rights issue or concentrated by a share buy back but this is relatively small in the context of the whole market. Almost all bonds have a maturity date and are loan arrangements where the borrower's needs will vary. The debt burden of governments, without exception, has been extended due to the global shocks of this century, increasing the supply of bonds to the market. Until now, central banks have soaked up large parts of this issuance as a means of keeping interest rates in the bond market low and making borrowing more attractive than ever. Central banks are now engaged in quantitative tightening (QT) where they are selling down their holdings of government and corporate debt. The Bank of England's Asset Purchase Facility held a peak of £895 billion of the stock of UK gilts, roughly a third of the total. In the twelve months to the end of September 2023 the Bank will have reduced its holdings by £80 billion but it estimates that the impact on yields is only around 10 basis points for the 10 year gilt. The Bank maintains that QT will operate in the background and the principal tool of monetary policy will remain interest rate management. 10 basis points would have been significant when interest rates were close to zero but in the 4% to 5% range the impact is much lower.

Returning to the case of the British government, debt is around 100% of GDP or in money terms, general government gross debt at the end of March 2023 was £2,537.0 billion. The last time debt was around the size of one's year's output of the nation was in March 1961, a time still in the shadow of the Second World War. The help provided to the borrower by high inflation (at the expense of the lender) is well illustrated by looking at the experience of paying down debts incurred by the country as a consequence of the war. In 1946 the country's outstanding debt was £27 billion, which was 270% of GDP. By 1976 the level of debt had risen to £64 billion but the economy had grown by thirteen times. As a result, the level of indebtedness had fallen from 270% of GDP to 49% of GDP. Those who have had the experience of 25 years of mortgage repayments would have, hopefully, felt a similar benefit of income growth versus monthly interest and capital repayment. This same effect was felt in August when the Office for National Statistics revised downwards the level of national indebtedness as tax receipts came in higher than expected. Year to date receipts were £10.4 billion above profile, which they attributed, in part, to higher profits, wage growth and inflation. Higher central bank spending was the flip side and was £8.0 billion above profile, in part reflecting higher than forecast public sector pay awards. Net debt in July 2023 was 98.5% of GDP, up 1.9% on a year earlier, but 4.0% below the March forecast thanks to both lower cash debt and higher GDP.

Two points emerge from this example which are that resilience to raised levels of debt is strong when the lender is a highly developed sovereign state and that the growth in debt is measured in nominal terms yet growth in GDP is measured in real terms. If we consider the growth in GDP and include inflation the positive effect of compounding helps greatly even as central government fails to balance the books year after year. As the United Kingdom's level of debt has grown rapidly – there have been seven years in the past fourteen when the government deficit has been over 7% of GDP, there does not appear to be a growing risk premium building into the yield asked for by the market. By far the greatest consideration, beyond default risk and the effect of QT, is expectations of future inflation and the consequential effect it will have on interest rates.

Forty years is quite a long time to hold on to memories yet thinking back to life in the 1970s conjures up clear images of high inflation, civil unrest and economic decline. Inflation grew out of control and dwindling living standards contrasted with the optimism of the 1960s. The last eighteen months have, to an extent, been a return to the past with a cost of living crisis, strike disruption and economic uncertainty and on the face of it that would appear to provide a deeply unfavourable environment in which to invest. This has been a period of financial re-adjustment. After the restrictions of COVID and the supply chain issues it created has come the good time spending of those accidental savings, as the Bank of England termed them. The sudden burst of inflation generated as Russian tanks rolled into eastern Ukraine has not been 'transitory', again quoting from the Bank of England lexicon and tight labour markets are successfully being rewarded with strong pay rises.

The IMF's current forecast for real world growth for 2023 is 3.0%. This is below the average of the last twenty years (2000 – 2019 averaged 3.9%) but will be remembered as a year when, in many countries, the defeat of inflation has been prioritised over economic growth. Banks are back in the spotlight as net interest rate margins grow but so do provisions for bad debts and, currently, the strength of the financial system is not being questioned. The optimist will note that the World Health Organisation announced in May that it no longer considers COVID-19 to be a "global health emergency" and that shipping rates and supply chains have largely recovered to pre-COVID levels with peak inflation passing. As these concerns abate, others replace them, such as the consequences of political tensions around the world and the risk of a sharp slowdown in China. These are, doubtless, subjects for future memoranda.

We continue to choose, where freely mandated, to invest in equities, either directly or via collective investments, typically exchange traded funds. All equity investors have their mettle tested from time to time and the investment experience is, clearly, not for all. The challenges remain but the relative attractions of equities against other asset classes appear strong to us, though some negative quarters are inevitable. Reference was made earlier to the 117 year data set recorded in the Credit Suisse Global Investment Returns Handbook 2023 and the ability of equities to absorb the vicissitudes of inflation over time, with the key words being "over time".