meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

This has been a strong quarter for bond and equity investors as expectation of an earlier and larger fall in official interest rates grew on the back of more optimistic inflation forecasts. Central bankers having been caught out earlier, when they underestimated inflation in 2021, are being cautious. However, optimism is prevailing at the moment, hence the very positive returns experienced in the latest quarter.

The tables below detail relevant movements in markets :

International Equities 31.10.23 - 31.01.24

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+14.1	+13.5	+19.1	+15.9
Finland	+9.9	+7.7	+13.0	+9.9
France	+11.5	+9.2	+14.6	+11.5
Germany	+14.0	+11.7	+17.2	+14.0
Hong Kong	-5.0	-9.4	-5.0	-7.5
Italy	+12.3	+9.9	+14.4	+12.3
Japan	+13.5	+12.1	+17.6	+14.5
Netherlands	+25.8	+23.2	+29.3	+25.8
Spain	+12.2	+9.8	+15.3	+12.2
Switzerland	+8.3	+9.5	+14.9	+11.8
UK	+5.5	+5.5	+10.7	+7.8
USA	+16.3	+10.8	+16.3	+13.2
All World Europe ex UK	+12.6	+11.2	+16.7	+13.6
All World Asia Pacific ex Japan	+5.9	+2.5	+7.6	+4.7
All World Asia Pacific	+8.6	+5.9	+11.1	+8.1
All World Latin America	+14.6	+12.1	+17.7	+14.5
All World All Emerging Markets	+5.8	+1.9	+6.9	+4.0
All World	+13.8	+9.7	+15.2	+12.1

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +6.1%

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

Currency	31.10.23	31.01.24
Sterling	4.51	3.79
US Dollar	4.93	3.91
Yen	0.94	0.73
Germany (Euro)	2.80	2.17

Sterling's performance during the quarter ending 31.01.24 (%)

Currency	Quarter Ending 31.01.24
US Dollar	+4.4
Canadian Dollar	+1.1
Yen	+1.4
Euro	+2.1
Swiss Franc	-1.1
Australian Dollar	+0.8

Other currency movements during the quarter ending 31.01.24 (%)

Currency	Quarter Ending 31.01.24
US Dollar / Canadian Dollar	-3.5
US Dollar / Yen	-3.3
US Dollar / Euro	-2.6
Swiss Franc / Euro	+2.9
Euro / Yen	-0.6

Significant Commodities (US dollar terms) 31.10.23 - 31.01.24 (%)

Currency	Quarter Ending 31.01.24
Oil	-6.0
Gold	+2.3

MARKETS

It has been a very strong quarter for international equity and bond markets. Looking firstly at equity markets, the total return on the FTSE All World Index in local currency terms was +13.8%, in sterling terms +9.7%, in US dollar terms +15.2% and, in euro terms, +12.1%. Looking at local currency terms firstly, the FTSE USA Index stood out with a total return of +16.3%. On the other end of the performance spectrum, the FTSE Hong Kong Index returned -5.0%. This related to the notable weakness in the mainland Chinese stock market. Positive but underperforming indices were the FTSE UK Index, +5.5%, the FTSE Asia Pacific ex Japan Index, +5.9%, the FTSE All World All Emerging Markets Index, +5.8%, and the FTSE All World Asia Pacific Index, +8.6%. Turning to the sterling adjusted indices, there were relatively strong performances from the FTSE Australia Index, +13.5%, the FTSE All World Latin America Index, +12.1%, and the FTSE All World Europe ex UK Index, +11.2%. Despite US dollar weakness, the FTSE USA Index, +10.8%, managed a modest outperformance.

In the international bond markets, there were significant falls in yields. Using ten year government bonds as a benchmark, the gross redemption yield on the UK gilt fell by 72 basis points to 3.79%, on the US Treasury bond by 102 basis points to 3.91%, on the Japanese Government Bond by 21 basis points to 0.73% and, on the German Bund, by 63 basis points to 2.17%.

In the foreign exchange market, the only currency which eclipsed sterling was the Swiss Franc. Against the Swiss Franc, sterling fell by 1.1%, but against the US dollar it rose by 4.4%, against the euro by 2.1%, against the yen by 1.4%, against the Canadian dollar by 1.1% and against the Australian dollar by 0.8%.

In the commodity markets, oil, as measured by Brent crude, fell by 6.0%, whilst gold moved up by 2.3%.

ECONOMICS

International equity markets have got off to a steady start in 2024 carrying on the momentum shown at the end of 2023, a performance which has continued to surprise many investors and followers of the stock market, given all the bad news which is around. Adding to the concerns apparent at the end of 2023, a further one has appeared in January, namely the attacks by Houthi rebels on Red Sea shipping thereby lengthening shipping journeys, causing some supply chain disruptions and, at least temporarily, raising prices. It is early days but, if the disruption continues, it threatens to raise the level of inflation.

The strong end to 2023 was driven by optimism that interest rates would start to fall in 2024 and at a faster rate than previously expected. The reason for this optimism on interest rates was the view that inflationary pressures would ease further following the steeper than expected fall so far from their peak. In other words, we could reach a “goldilocks” situation of inflation near central bank target rates of around 2% and the avoidance of a recession. Those who are sceptical about equity markets’ current strength would say that they are priced for perfection and that may well be so. But there is a world of difference between believing that markets have temporarily run ahead of themselves and may be due for a setback and believing that markets are so overvalued and in danger of a serious fall that it is desirable to risk taking down a large portion of equity holdings as protection and holding cash. The latter would be a big decision with potentially greater risks than remaining invested. Why is this? In investment, time horizons should be long. None of us has a crystal ball and it is impossible to know how markets are going to perform in the short term but, in the longer term, equities move up. Other things being equal, taking precipitate action in response to a seemingly dangerous and unexpected event can be very costly because an investor's confidence increases as markets recover and by then coming back into the market at a new higher level almost certainly means that performance will be permanently impaired. If we look back at the chart of the FTSE All World Index going back to the turn of the century, the dot.com bubble burst in the early part, and whilst it was painful at the time, it now looks a mild setback and those who sold out then will have had plenty of regrets. If we just take one example, a big one at that, Microsoft Corporation. It endured a rough time like many tech stocks in the early years of the century and really didn't do anything for a long time but started to charge ahead from 2015 and has never looked back since showing a compound annual growth rate from 2000 to date of around 10.5%. And, of course, there are others like it. But even with the benefit of hindsight, the dot.com bubble did not seem like an event which should cause a major shift in asset allocation away from equities. The Global Financial Crisis (GFC) in 2008, in fairness, did seem a more seismic event because it called into doubt the world's financial system and it was a frightening time. It did call for strong nerves but, in times like that and in the early days of Covid, it was always important to consider what governments and central banks are likely to do to try to stabilise the position. This is probably a lesson which investors have taken on board. Cutting interest rates and printing money, in particular, are good for asset prices, through potentially store up long term problems, and they were meant to be in the circumstances of the time to try to restore confidence. Those who took this view and held firm have been handsomely rewarded. Those who bailed out have probably regretted it in a big way. There is, of course, a big lesson here. If one purchases equities, one has to be certain that, if we do experience worrying events, geopolitically or economically, one can see through the very difficult times before they improve again. That brings us to Covid, the full enormity of which hit markets in February 2022. So, in the performance graph of the FTSE All World Index since 2000, this shows up very markedly but only for a short time before moving up again, and, as we write, standing at around record levels. And, why is this? Because central banks and governments acted quickly to support their respective economies, causing investor confidence to return. One lesson we draw from this is that investors appreciate that the authorities will do what they can to stabilise the position and that reacting to bad news in a hasty manner might be costly.

The point of this quick journey through the crises and problems so far this century and subsequent stock market reactions is to relate it to where we are at present in markets. In 2023, markets faced a continuation of the Russia / Ukraine war and then the Hamas attack on Israel in October, with all the potential consequences which this entailed, yet equities ended the year higher, admittedly driven strongly by the performance of the "Magnificent Seven" US equities. Now, in January 2024, there have been attacks by the Houthi rebels on Red Sea shipping with the potential consequences mentioned earlier and stock markets have remained unmoved.

So, the question is whether equity investors are burying their heads in the sand and not listening to those who question their investment thinking or could they be right in maintaining their preference for equities? But before answering this question, it is important to note the composition of the stock market's strength, particularly in the USA. It was the "Magnificent Seven" tech stocks which drove the US market in 2023, these companies being Apple, Amazon, Alphabet, Meta, Microsoft, NVIDIA and Tesla. However, an equal weighted S&P 500 would have shown very little growth last year and, on portfolio diversification grounds, one is going to have a mixture of value and growth stocks, so many investors' US portfolios will have underperformed the S&P 500 but for good reasons. If sentiment turns against the Magnificent Seven, one would expect a more sectorally balanced portfolio to outperform one concentrated with these types of stocks. Having said that, let us look at actual and potential challenges for international equity markets in 2024. On the geopolitical front, the Ukraine/Russia and Hamas/Israel wars look likely to dominate the news. The human aspect of these wars remains chilling. It seems callous to say that the economic effects, particularly on energy availability and pricing, have been worked round but future developments remain uncertain. The recent Houthi attacks on Red Sea shipping represent another unwanted development with potential consequences for supply chain disruption and inflation if they continue. Escalation of the war in the Middle East remains quite possible bringing with it more uncertainties. Then, there is China with the perennial concern about the possibility of it invading Taiwan, a conflict which would very likely bring in the involvement of foreign powers, notably the USA. The recent Taiwan Presidential election did not yield China's preferred result and, although the odds seem to against anything happening this year, it remains an unstable situation. Besides unpredictable military consequences resulting from an invasion, Taiwan's role as the world's major semiconductor producer would show up huge vulnerabilities in the world economy. But, absent this military development, China's economy also affects the rest of the world. Here, there are significant problems. The recovery from the Covid lockdown has not been as strong as expected with Chinese consumers showing caution. The problems of the property sector, upon which a lot of Chinese growth has depended, are serious and this is having a detrimental effect on sentiment. The woes of the Chinese stock market partly reflect this negative property background but also the capricious nature of official policy towards the private sector. Foreigners are disinvesting fast for economic and political reasons. Chinese economic weakness will have a negative effect on the international economy. Staying in Asia, North Korea becomes ever more aggressive towards South Korea and its enemies in general and who knows what it might do with it arsenal of weapons, including nuclear ones?

Then, there is the politics which we often regard as important as the economics in our assessment of the investment outlook. This is an important year for elections, over forty of them, with probably the most important one being in the USA. Nowhere has politics become more personalised than in the USA and, as this is written, the most likely contest for President will be between Joe Biden and Donald Trump. For obvious reasons, personalities are dominating US politics as present but, as investment managers, we have to try to put them out of our mind and concentrate on policies, particularly economic ones as they affect businesses, individuals and the economy. We are not taking any position on Donald Trump but it is right to acknowledge that in his term as President he was able to get market friendly policies through Congress, bringing down the uncompetitive rate of US corporate tax from 35%. Interestingly, the JP Morgan Chase CEO, Jamie Dimon, at Davos praised the former President's position on policies in the area of taxation and the economy. This is not to say that a second term for Donald Trump would be good for markets economically. He has talked about a 10% import tariff which would be a highly retrograde step with seriously damaging international economic consequences. Joe Biden, on the other hand, has been frustrated in his plan to raise corporate and personal taxes because of Congress and these taxation policies would not be market or investor friendly. It's not only the Presidential election result which will be important for investors, it will be those in Congress. The present split Congress, with the Democrats controlling the Senate and the Republicans the House of Representatives has meant elements of a stalemate, not a bad background for investors because it removes some uncertainty.

An area which we have started to write about in recent reviews, because it does have potential for an adverse effect on markets, is regulatory creep. We are seeing this in the USA, UK and Europe. In the USA, for example, the President through his executive power has appointed people who reflect his political views to positions of influence. In the area of competition regulation, high tech and the airlines are finding it more difficult to seal deals because of regulatory intervention. Companies in the USA do have the advantage of being able to appeal decisions with some chance of success. The UK seems pretty aggressive in trying to block acquisitions, the tech sector particularly coming under fire although the Competition and Markets Authority did back down in the case of Microsoft Corporation's acquisition of Activision Blizzard following some concessions from Microsoft. The situation is particularly bad in the UK because the UK is trying to attract high tech investment, particularly post Brexit and one senses government frustration over some of the activities of the CMA. It is difficult to know whether it is ideology behind some of the CMA's actions but its activities have been well noted and are not good for the UK taking the wider picture of the country's economic needs. Whether one agrees with it or not, M&A activity is helpful to markets.

These, therefore, are some of the obvious "known unknowns" to paraphrase the late Donald Rumsfeld, the former US Defense Secretary but, as the year progresses, we will surely discover that there are also "unknown unknowns". It is just that these days there seem to be more of them.

One of the figures which one would like to know is how different economies will perform in 2024 and 2025 in terms of growth and inflation. Those figures would provide a useful handle on which to base equity and fixed interest forecasts. We should perhaps be most interested in what the forecasts have to say about inflation since the stock market rally at the end of 2023 was due to hopes for a "goldilocks" economic outcome, meaning the avoidance of recession and inflation coming back towards central banks' target inflation rates which would allow central banks to start reducing interest rates. Obviously, the USA is going to be key. Given the sharp rise in interest rates in 2023, its growth rate was surprisingly strong at 2.5%. There is, of course, always a lag between the timing of interest rate changes and their economic effect so more of the effects will come through in 2024. In its November 2023 forecast, the OECD was looking for growth of 1.5% in 2024 and 1.7% in 2025. Whilst this would represent modest growth by US standards, the prospective P/E ratio of around 20 on the S&P 500 is not outrageous and, by itself, not a reason to sell US equities, which represent an important part of our clients' portfolios. This would represent an earnings yield of around 5% which compares with the 10 year US Treasury yield of around 4.1%. This suggests that whilst it may not be a banner year for US equities, there is no strong case for selling the market. This is in the context of our earlier comment that taking significant decisions to sell down an equity position really would need to be taken in the context of the political or economic outlook being much worse than it is at present. The potential loss of profit for long term investors involved in making hasty decisions should always be at the forefront of investors' minds. And really this is the same view that we could take on Europe. Growth prospects in the eurozone are very modest this year. The OECD in last November's forecast put the euro area's growth rate at just 0.9% this year and, within that, the forecast for the largest economy of all in the euro area, Germany, at just 0.6%. The eurozone faces significant issues, one of which is a relatively inflexible economic model signified by a high degree of regulation. We highlighted earlier the role of regulations in making growth more difficult in certain industries and it is no surprise that the eurozone has so few high technology companies compare with the USA. On top of that, the area is not really suited to being in a single currency because of disparities in economic performances. Because of the lack of currency flexibility, some countries have become uncompetitive and find it hard to grow and all this is important in the context of some large budget deficits and over large levels of public debt as a percentage of GDP. These factors come together to provide the rationale for some low ratings in European stock markets compared with the USA. Because European shares are more lowly rated, there are signs of value. The dividend yields on most major eurozone markets are above the respective countries' ten year government bond yields and, even though the growth outlook is very modest, corporate earnings are expected to creep up this year. Whilst economic growth forecasts are very modest, the equity markets do not look expensive and exposure to high quality equities complements a much larger exposure to the USA. But the politics of Europe is unpredictable. There are European elections this year and a significant change in the composition of the EU Parliament is expected. As this is written, there are major protests by farmers against policies they say will hit them hard and they have the power to cause economic damage. At the heart of many of these protests are the effect which "green" policies are having on them and, as we saw in the Dutch elections last year, the farmers have very significant public support. These events could turn into a market factor this year in the EU.

The UK market remains unloved and underperformed again last year. It does not, of course, have the high tech stocks which the USA has but it is heavy in traditional sectors like oil, mining and finance. At times, such as in 2022 when the UK market significantly outperformed, it was because of some of these unfashionable sectors and their time may come again. The market is certainly not expensive on a prospective P/E ratio of around 11 but the dividend yield is close to the ten year government bond yield and the relationship not quite as favourable as in Europe. With a General Election almost certainly going to be held this year (January 2025 is the latest date) there will be uncertainty. We have always emphasised the dangers of home bias. The UK is not a large market these days in relative terms and it is difficult to advance a reason for a meaningful overweighting. We continue to believe that sterling based equity investors should have a significant majority of their equity exposure outside the UK with the USA which is, of course, by far the biggest market, the main area of weighting. We will also typically invest in Asia and Australia, all markets with positive features as well as obvious risks and we avoid China, other than indirectly through exposure to more broadly Asia based exchange traded funds.

So far, we have discussed equities exclusively but is there any reason to change our long standing negative view of the fixed interest market? To simplify, this was because monetary policy had suppressed yields to levels which bore no relation to reality in order to try to stimulate world economies during the Global Financial Crisis and Covid 19. It was never realistic to believe that very low and, in some cases, negative yields could be sustained indefinitely. Negative real yields can never represent an attractive investment opportunity and it was only a question of time before reality broke through. This happened when central banks failed to raise interest rates in 2021 when it became clear to most people that inflation was starting to rise, exacerbated a little later by the inflationary effects arising from the Russian attack on Ukraine. The price risks to bonds were obvious and 2022 turned out to be a disastrous year for them. Their reputation as a moderating influence on the volatility of equities was trashed in 2022 when the inverse correlation with equity movements completely broke down. The sharp rise in prices towards the end of 2023 saved bonds from a negative performance but they underperformed world equity markets.

The big fall in bond prices and therefore the sharp rise in yields at a time when inflation has fallen back has clearly improved the relationship between inflation and yields so that, on that score, their relative attraction has improved. At the time of writing and using ten year government bonds as a yardstick, we see the US Treasury bond with a gross redemption yield of 3.89% and core inflation at 3.9%, the UK with respective figures of 3.81% and 5.1%, Germany at 2.17% and 3.4% and Japan at 0.66% and 2.3%. So, whilst there is a slight positive real yield on the US Treasury bond, real yields are negative elsewhere and overall the relationship, whilst much better than it was, does not make the case for bonds at all compelling. We also have to look at the technical position. There are some very large budget deficits which have to be financed. Economist Intelligence Unit estimates for budget balances for 2023 are -6.3% for the USA, -5.1% for Japan, -3.9% for the UK, -5.0% for France, -5.3% for Italy and -4.1% for Spain to give some examples. On top of this, quantitative tightening (QT) is taking place in the USA, UK and eurozone as central banks' fixed interest holdings are sold back to the private sector or maturing bond yields no reinvested. Even though this may not have been the case in the past, intuitively one feels that the pressure of this additional supply on to the market will affect prices. One of the issues we touched upon in 2023 was the political strain in the eurozone bond market arising from some members' very high indebtedness levels and we noted, for example, that, at one stage, the difference in gross redemption yields between German and Italian ten year government bonds has widened to over 200 basis points which could be interpreted as a sign of stress. Italy is, of course, a heavily indebted country with a public debt to GDP ratio at around 150%. The relative yield relationship has now improved with the gap at around 150 basis points. However, there is no room for complacency and debt levels are a concern. We would summarise our view on bonds as being that they are less unattractive than they were but not yet showing yields which reflect inflation and over indebtedness in some countries.

As this is written, Wall Street is hitting new highs and, yet, as one looks at the news, which seems unrelentingly bad, one cannot help feeling that there is some disconnect. Are investors just burying their heads in the sand? It may seem a trite thing to say but investors have to place their money somewhere. As we have aimed to show in this review and in previous ones, bonds are not the safe low volatility assets which moderate the volatility more traditionally associated with equities. For us, to consider them attractive, we would want to see some meaningful real yield which is not the case at present. Cash as an asset class, rather than a home for opportunistic money, might have the advantage over bonds in that its nominal value will not change. With the slope of the yield curve, cash may look to have an attractive yield but is the outlook so bad that one would risk missing the upside on equities to stay in cash as an asset class? Some commentators think that the world is closer to a nuclear war than ever given the amount of bad news around. But it is not flippant to say that if such a situation occurred, a lot of this may be academic anyway. In the more realistic prospect, hopefully, that all of these potential problems are contained, albeit at some cost and, in the case of the world economy, this could mean higher inflation, we would not consider the situation so bad as to take a major decision to change our asset allocation by downgrading our equity exposure. So far this century, equities have managed to withstand some really strong headwinds, the dot.com crash, the Global Financial Crisis and Covid. All this is predicated on investors taking a long term view and being completely comfortable with the characteristics of equities for, although the year has started off well, the turbulent geopolitical background surely means that there will be price volatility in 2024.