meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Equity markets have experienced a strong quarter with the dominant US market having a particularly positive effect as a result of strength in the technology giants. On the other hand, bonds moved in the other direction, influenced by the inflation and interest rate outlook. There were some quite large currency movements, noticeably in the yen, which was weak. Commodity prices have staged a partial recovery over the quarter.

The tables below detail relevant movements in markets :

International Equities 28.04.23 - 31.07.23

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+2.3	+1.9	+4.3	+4.4
Finland	-6.2	-8.5	-8.5	-6.2
France	+1.5	-1.0	+1.4	+1.5
Germany	+3.2	+0.7	+3.1	+3.2
Hong Kong	-2.9	-4.5	-2.2	-2.1
Italy	+10.4	+7.7	+10.2	+10.4
Japan	+13.5	+6.3	+8.8	+8.9
Netherlands	+8.9	+6.2	+8.7	+8.9
Spain	+5.4	+2.8	+5.3	+5.4
Switzerland	-1.1	-0.8	+1.5	+1.6
UK	-1.2	-1.2	+1.1	+1.3
USA	+10.9	+8.3	+10.9	+11.0
All World Europe ex UK	+2.6	+0.3	+2.7	+2.8
All World Asia Pacific ex Japan	+6.0	+4.3	+6.7	+6.9
All World Asia Pacific	+8.6	+4.9	+7.4	+7.6
All World Latin America	+10.8	+14.4	+17.1	+17.2
All World All Emerging Markets	+8.2	+5.7	+8.2	+8.3
All World	+8.5	+6.0	+8.5	+8.7

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -3.1%

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

Currency	28.04.23	31.07.23
Sterling	3.71	4.31
US Dollar	3.42	3.96
Yen	0.38	0.60
Germany (Euro)	2.31	2.49

Sterling's performance during the quarter ending 31.07.23 (%)

Currency	Quarter Ending 31.07.23
US Dollar	+2.2
Canadian Dollar	-0.5
Yen	+6.6
Euro	+2.3
Swiss Franc	-0.4
Australian Dollar	+0.6

Other currency movements during the quarter ending 31.07.23 (%)

Currency	Quarter Ending 31.07.23
US Dollar / Canadian Dollar	-2.5
US Dollar / Yen	+4.7
US Dollar / Euro	+0.2
Swiss Franc / Euro	+2.8
Euro / Yen	+4.5

Significant Commodities (US dollar terms) 28.04.23 - 31.07.23 (%)

Currency	Quarter Ending 31.07.23
Oil	+6.6
Gold	-1.6

MARKETS

A strong quarter for international equity markets has been reflected in a total return on the FTSE All World Index of +8.5% in local currency returns, +6.0% in sterling terms, +8.5% in US dollar terms and +8.7% in euro terms. Looking at local currency returns first, the outstanding performers were the FTSE USA Index, +10.9%, the FTSE Japan Index, +13.5% and the FTSE All World Latin America Index, +10.8%. At the other end of the scale was the FTSE UK Index which returned -1.2%. Looking at sterling adjusted performances, the FTSE All World Latin America Index, +14.4%, moved to the top, whilst the FTSE USA Index, +8.3%, and the FTSE Japan Index, +6.3%, remained above average performers.

In the fixed interest market, international bonds represented by 10 year government bond yields had a weak quarter. The UK government bond saw its gross redemption yield rise by 60 basis points to 4.31%, the US Treasury bond by 54 basis points to 3.96%, the Japanese Government Bond by 22 basis points to 0.60% and the German Bund by 18 basis points to 2.49%.

In the foreign exchange market, the strongest currencies were the Canadian dollar, against which sterling fell by 0.5%, and the Swiss Franc, against which sterling fell by 0.4%. On the other hand, sterling appreciated by 6.6% against the yen, by 2.3% against the euro, by 2.2% against the US dollar and 0.6% against the Australian dollar.

In the commodity markets, oil, as measured by Brent crude, rose by 6.6% as OPEC's supply restrictions started to take effect. Gold fell slightly by 1.6%.

ECONOMICS

It is only just over half way through 2023, so obviously the background can change over the next five months but, looking back at markets since the beginning of the year, their performance has undoubtedly surprised many investment managers and investors because they have not performed as many expected. Back in December 2022, we were looking at really disturbing inflation levels (8.1% in the USA, year on year in November, 8.4% in the euro area and 8.0% in the UK) and the general view was that central banks would have to continue to raise policy rates (the rate they use to implement or signal their monetary policy stance) to try to squeeze inflation from the system. To some, this did not appear to be a propitious background for equities on the basis that rising interest rates could push economies into recession and, therefore, provide an unpromising background for corporate earnings and, perhaps, dividends. It did not appear to be a good prospect for fixed interest securities either. Although yields had risen substantially after a long period of ultra low interest rates and Quantitative Easing ("QE"), they did not appear appealing, given the level of inflation. At the end of 2022, the gross redemption yield on benchmark 10 year government bonds was 3.66% for the UK gilt, 3.88% for the US Treasury bond, 0.41% for the Japanese Government Bond (although this is always a special case) and 2.56% for the German Bund. And the reason why many in the investment world were at best cautious about equities? Rising interest rates mean that future corporate cash flows are discounted at a higher rate, meaning a lower net present value of these cash flows. This was not supposed to be good for those companies' shares, many in the technology sector whose earnings may be well out into the future and uncertain, but the thinking also applied to more established companies. In fact, so far this year, this has not worked out as these sceptical investors may have expected and seems to have turned the received wisdom on its head. If we look at the technology heavy NASDAQ, at the time of writing it has returned about 36% in US dollar terms and about 29% in sterling terms so far this year. The S&P 500 has returned about 19% in local currency terms and nearly 13% in sterling terms. The performance of the S&P 500 Index does not tell the whole story because the rise has been fuelled by the performances of the major US technology companies, leaving many other companies' shares looking very lacklustre. So, the performance of the S&P 500 Index has not been fully reflected in many investors' portfolios. Looking around world markets, there have been many good performances from European markets and Japan but, elsewhere, China, like the UK, has significantly underperformed. Bringing this altogether in the FTSE All World Index, it has produced a very acceptable year to date total return of about 9% in sterling terms and 16% in local currency returns. In the bond markets, the Bloomberg Global Aggregate Total Return index has so far edged just 2.1% higher this year in US dollar terms but, after a disastrous 2022, the FTSE Actuaries UK Conventional Gilts All Stocks Total Return Index has shown a return of -3.4%, so is still struggling with underperformance against other markets.

Discussing, firstly, the performance of international equity markets so far this year, we can rationalise the performance of the S&P 500 Index. If we take the example of the two largest components of the S&P 500 Index, Apple Inc. and Microsoft Corporation, and it can apply to others as well, we see technology companies whose earnings are not well out into the future but are here now and growing so the discounting of future cash flows at higher rates of interest does not have such a negative effect as it would do on more speculative companies. These companies are often cash rich, make profits, pay dividends and buy back their shares. But what has struck a chord with investors in the sector in recent months has been the evolution of Artificial Intelligence ("AI") into a major stock market story and the realisation of its enormous potential, surrounded by all sorts of uncertainties as to its consequences, many of a moral and ethical nature. These are obviously very important and governments and regulators are becoming more involved and are moving urgently. However, these issues are really outside the remit of this review and we will just discuss some of the investment consequences deriving from AI's effects on the world economy which have caused such excitement amongst investors. In the world of medicine, for example, the ability to crunch vast amounts of data should speed medical advances. For businesses and governments, it should enable users to cut out some costs and become more efficient and productive. Accuracy, the ability to operate around the clock and the replacement of repetitive tasks are some other benefits of AI. This is a vast subject, but the point of mentioning it in this review is that it may be the new "big thing" for the stock market, which has a greater effect on share prices than the state of the world economy. Ever since Nvidia, the company which makes computer chips which can run graphics heavy video games, produced blockbuster results and forecasts in May, the increased awareness of AI and what it could mean helped to galvanise the sector. AI researchers began using these chips to run the powerful new algorithms which were causing breakthroughs in the field of AI. Nvidia's results highlighted already growing awareness of AI and has been an important market factor for US equities this year. Whilst the broader US equity market has not moved much this year, the tech giants have driven the S&P 500 and NASDAQ markets ahead.

At a time when a brutal war is being fought in Ukraine, it seems almost callous that markets should be buoyed by a development like the news from Nvidia and the effect which it has had on the technology sector. It is worth dwelling on some of the issues which could weigh on markets in other circumstances. Clearly, no one knows what the end game is going to be in Ukraine. That may smack of complacency because it is uncertain how Putin will react if Russia is cornered. There is also the ongoing dispute between China and Taiwan. Again, that has the potential to turn ugly and a bad outcome in either would significantly affect markets. We saw during Covid-19 how supply chain difficulties raised inflation levels. This could happen again. That would cause markets to re-evaluate any complacency they were showing about geopolitical events.

However, if we look at more normal factors which affect stock markets, like inflation and interest rates, we have to judge the root of the problems. In terms of inflation, it is core rates (i.e. excluding erratic items like fuel and energy which are now lowering headline inflation). These have been well over central banks' targets. Current rates of core inflation are as follows :

	%
UK	6.9
Spain	6.2
Netherlands	6.1
Australia	5.9
France	5.7
Germany	5.5
Euro area	5.5
Italy	5.2
USA	4.8
Japan	3.3
Canada	3.2
China	0.4

If we say that central banks generally have an inflation target of 2%, we see that there is still a significant problem, which accounts for some continuing hawkish comments from central bankers. Their fear is that current inflation levels become embedded in people's expectations, leading to pay demands which match or exceed current inflation levels and which, if granted, would help to embed inflation in the system. The normal monetary way to deal with this would to be to weigh down on demand by raising interest rates perhaps leading to a recession. Of course, this course of action would not be welcomed by politicians with their relatively short time horizons, but central banks, having failed to anticipate inflation in 2021, will not want to be caught out again. A danger to the stock market is that wages may be what economists call "sticky" on the downside and that inflation is slow to respond to tighter monetary policy so that interest rates have to remain higher and higher for longer than expected to bear down on inflation. Markets may be too sanguine about interest rates. Besides moving policy rates, the other tool which central banks have been using is quantitative tightening ("QT"), in the course of which they sell back assets to the private sector and suck money out of the system by reducing banks' reserves at the central bank. This effectively takes money out of the economy, reduces economic activity and bears down on inflation and increases the risk of a recession. For central banks this is not such of an issue given that their primary target is inflation but, for governments, the political costs of recession are usually high. It is against this background that there has been some talk of governments giving central banks a higher inflation target, the rationale being that the monetary medicine would not have to be so strong. Such a move could be dangerous. Current targets of around 2% are usually considered to be about the correct level. This is because there is just enough inflation for consumers to consider discretionary expenditure worthwhile in the sense that holding off would increase the cost later on but it would not be high enough to introduce the most pernicious effects of inflation. If we look at the opposite experience in Japan, where deflation was a problem in the past, the prospect of falling prices caused discretionary purchases to be delayed as consumers thought that they could buy the items more cheaply later on thereby risking an economic recession. So, for many economists, the trade off between a 2% inflation target and enough incentives to make purchases and stimulate economic activity seems about right. Embedding high inflationary expectations in people's minds as seems to be happening now, the UK being a good example with the high incidence of strikes, is a central banker's worst nightmare.

So, what does this mean for investors? We have an international equity market which has surprised some observers with its good performance so far this year. However, in the US market, which has overall performed very well, the performance has been heavily skewed to the big technology companies and a particular theme, AI, has sparked further interest in the sector, as we discussed earlier on. Traditional thinking, as touched upon earlier, is that rising interest rates would affect equities and that these high, or potentially high, growth companies' shares would underperform. That his has so far not happened this year and it appears to be dragging some sceptical investors back into equities for fear of missing out.

Another reason why equities could have done well this year is that investors are anticipating the peak of interest rates and the prospect of reductions after that. As markets look ahead, that would be quite rational, but would investors who took that view be right? Whilst core inflation rates are still so high, central banks are likely to err on the more hawkish side given earlier miscalculations. Another reason why medium and longer term bond yields might be sticky on the downside is that the supply situation is unhelpful. Large budget deficits are being run almost everywhere and these have to be financed. Additionally, where central banks are undertaking QT, a further supply of securities comes on to the market, so markets will have a lot of new and existing issuance to absorb. At a time when governments have seen outstanding public debt as a percentage of GDP rise sharply, credit risks increase and this could be reflected in interest rates that purchasers of bonds are prepared to accept. So, for example, in the UK, government bonds have underperformed this year, certainly because of relative inflation issues but also, one suspects, because of the supply issues touched on above. What all this is pointing to, in our mind, is that, although nominal yields appear much more attractive than they were, in inflation adjusted terms they are still negative and, given the probability of central banks raising interest rates still further because of fears about "sticky" inflation and the large supply of bonds coming on to markets, it is hard to make a strong case for them.

Whilst we think the case for bonds remains weak, we can see better prospects for equities, although it is not one way. The interest rate rises which we have seen will progressively weigh on economic activity and real disposable incomes will come under pressure. We can see, particularly in the UK as home owners come off low interest rate mortgages, that the pressure on incomes will be quite severe although, to be balanced, many savers who have suffered from low interest rates will now benefit from higher interest rates. The US commercial property market is a concern, to look at one of the issues in the USA, which is worrying many people. The Chinese economy is not recovering as many had hoped after the lifting of the most recent Covid-19 restrictions and China remains vital for the world economy. And then there is the uncertain course of the energy outlook so damaged by the Russian invasion of Ukraine.

Economic growth forecasts in the short term are modest but at least there is some growth to support, if not enhance greatly, company profits. The IMF has just published its latest World Economic Outlook growth projections. Compared with its April forecast, it has upgraded the world growth outlook this year by 0.2% to 3.0% and has slightly reduced its global inflation forecast for this year to 6.8%, 0.2% lower than its April estimate. It forecasts world economic growth in 2024 at 3.0%, the same as this year. Advanced economies are forecast to grow at 1.5% this year and 1.4% next year. The only country forecast to show negative growth this year is Germany whose economy is expected to contract by 0.3%. Emerging Market and Developing Economies are forecast to grow by 4.0% this year and 4.5% next year. Within those figures, the IMF sees China's growth at 5.2% this year and 4.5% next year, with India growing faster in both years at 6.1% and 6.3% respectively. Of course, these figures will change as events unfold but, given the background, they represent something for equities to build upon, do not imply a collapse in profits or dividends and suggest that they have relative attractions against bonds which, unless inflation falls sharply, have little going for them, in our view.

In our June 2023 review, we spent some time analysing the political situation in the USA and UK in as far as they were influences on the markets since, at certain times, politics can be as important as economics in determining investor attitudes. One result of the pandemic and, latterly, the Russian attack on Ukraine, with the economic consequences in the shape of rising inflation, has been an increasing hostility to business and, more broadly, an anti wealth feeling in many quarters. For politicians, with their short term horizons, these can be easy targets but these sentiments and actions also come at a cost. An example we gave in our last review was the windfall taxes on energy companies imposed in the UK. With rising oil prices, although they are now well off their peak, and the consequent rise in profits, they were an easy target, although those advocating these taxes failed to mention the huge losses made when the oil price collapsed during Covid-19. Investors notice this asymmetry which has wider implications for the market in general. The irony is that the UK government wants to license more North Sea blocks and, not surprisingly, the windfall taxes have undermined these ambitions. In the USA, we pointed out some negative implications from President Biden's proposed 2023 budget which included some hefty tax rises on businesses and certain high income earners, certainly a negative for the equity market. However, at present he would be unable to get this through Congress as the Republicans control the House of Representatives. So, at the moment, the business and investment climate looks rather better in the USA than UK. With the US elections coming up in November 2024, that position may change but, for now, although the US equity market is much more highly rated than the UK, it looks a rather safer place and this certainly informs our investment thinking. One market where politics has certainly affected the market is China. Companies' fortunes are now at the whim of the authorities. The technology sector has been badly affected by the government's actions against individuals, including not only restrictions on them but on the business they do. It is fair to say that companies work for the state and shareholders come a long way behind. It is no wonder that the Chinese equity market has been such a poor relative performer as investors have had very little visibility on occasions and cannot evaluate shares in the normal way.

In our June review, we also touched upon anti trust issues which could affect market valuations and, in particular, issues in the UK and USA. In both countries there are activist regulators who appear to be pushing the boundaries of intervention. M & A activity can, at times, be an important market catalyst but overly aggressive action can inform outsiders' opinion of a country as a place to do business and, through that, affect market valuations. The anti trust regulators in the USA, the FTC and Department of Justice, appear to have moved into the realms of political activism, with technology companies and healthcare companies being under scrutiny. The case we discussed in our June review was Microsoft's agreed acquisition of Activision Blizzard. The strange situation occurred where the EC had cleared the purchase but the CMA in the UK blocked it, whilst the FTC in the USA was also trying to block it. Two US courts sided with Microsoft when the FTC sought to stop the deal and there seems to be some movement from the CMA in the UK. Technology companies, with Microsoft in the fore, have been vociferous in their complaints about the UK's attitude of seeming hostility towards the sector at a time when the government is trying to attract companies to the sector post Brexit. Whatever the rights or wrongs of the CMA's actions in the UK, complaints from companies like Microsoft do get listened to and affect views on the UK and, by extension, the stock market.

In terms of our international equity asset allocation, it is pleasing to see that the UK equity market has performed strongly in July, although this does not make noticeable inroads into its year to date underperformance. On the face of it, UK shares do look good value on a relative basis, but the "old economy" profile of the UK equity markets is now out of favour relative to the growth stock nature of the big US companies which dominate the S&P 500 index. With real incomes under pressure for many people in the UK, political and regulatory pressure on companies is bound to continue and the flipside is that this is not good for investors. This is one reason why we continue to emphasise strongly the need for equity portfolios to have significant geographical diversification. For the moment, given the amount of time before the US Presidential and Congressional elections in November 2024, investors in the US equity market can feel reasonably relaxed about any significant actions likely to affect companies and themselves. However, nearer the time, when there is perhaps a clearer view of the likely outcome of these elections, we may need to review the position.

So, how do we summarise all these conflicting factors for fixed interest and equity investors and bring them together in a coherent investment policy? When cash and fixed interest yields were minuscule, or even negative, in some markets in Europe and Japan, it was not difficult to make a strong case for equities, based on yield differentials, even though the economic background was uncertain post Covid-19. Now, with the rapid and sharp increase in interest rates, fixed interest securities post a much stronger challenge to equities, although, so far this year, equities have seen off that challenge in many countries including the USA and Europe ex UK. In the US markets, we have talked about AI being a possible game changer for markets, with Nvidia's results and forecasts bringing even more to the fore the possibilities which AI presents for the world economy. Something like the potential for AI can trump economic indicators as a market influence. Whether this phenomenon will continue to drive US equity markets remains to be seen. However, whilst higher nominal interest rates, even if negative in real inflation adjusted terms, do pose a challenge, we believe that the technical side of the bond market, involving huge issuance of government debt to fund very large borrowing requirements, will limit the return possibilities, particularly if investors start factoring in additional credit risks. The economic outlook, as detailed in the IMF's economic forecasts earlier in this review, is not exciting, but neither is it disastrous given the geopolitical background and its effects on inflation. Corporate earnings and dividends should be good enough to support markets at these levels. For us, these competing factors still come out on the side of equities. However, there will be bumps along the way. We do not know how the war in Ukraine will unfold and this could have a major effect on markets both ways. But our approach is long term and we have to accept that markets will have setbacks but, unless the outlook is unusually serious, we are always mindful of the danger of being out of the equity markets where investors may suffer a significant opportunity cost if share prices move ahead again as they do over time.