meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Given geopolitical and economic uncertainties, international equity markets can be considered to have held up well in the second quarter of 2023. Bond markets, particularly that of the UK, have had a difficult quarter against the background of rising interest rates and still stubbornly high inflation rates. The prospect of sterling interest rates reaching higher than previously expected levels has buoyed sterling.

The tables below detail relevant movements in markets:

International Equities 31.03.23 - 30.06.23

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.1	-2.3	+0.5	N/C
Finland	-6.7	-8.8	-6.3	-6.7
France	+3.6	+1.1	+4.0	+3.6
Germany	+3.2	+0.7	+3.6	+3.2
Hong Kong, China	-5.1	-7.5	-4.9	-5.3
Italy	+8.0	+5.5	+8.5	+8.0
Japan	+15.0	+3.0	+5.9	+5.4
Netherlands	+3.7	+1.3	+4.1	+3.7
Spain	+5.6	+3.1	+6.0	+5.6
Switzerland	+2.3	+1.6	+4.5	+4.1
UK	N/C	N/C	+2.8	+2.4
USA	+8.7	+5.7	+8.7	+8.3
All World Europe ex UK	+3.2	+0.6	+3.4	+3.0
All World Asia Pacific ex Japan	+0.2	-3.2	-0.5	-0.9
All World Asia Pacific	+5.1	-1.1	+1.7	+1.2
All World Latin America	+9.3	+11.5	+14.7	+14.2
All World All Emerging Markets	+1.4	-1.9	+0.9	+0.4
All World	+6.7	+3.4	+6.3	+5.8

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -5.4%

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

Currency	31.03.23	30.06.23
Sterling	3.48	4.38
US Dollar	3.47	3.84
Yen	0.32	0.39
Germany (Euro)	2.29	2.39

Sterling's performance during the quarter ending 30.06.23 (%)

Currency	Quarter Ending 30.06.23
US Dollar	+3.0
Canadian Dollar	+0.9
Yen	+11.9
Euro	+2.3
Swiss Franc	+0.7
Australian Dollar	+3.3

Other currency movements during the quarter ending 30.06.23 (%)

Currency	Quarter Ending 30.06.23
US Dollar / Canadian Dollar	-2.0
US Dollar / Yen	+8.6
US Dollar / Euro	-0.6
Swiss Franc / Euro	+1.5
Euro / Yen	+9.3

Significant Commodities (US dollar terms) 31.03.23 - 30.06.23 (%)

Currency	Quarter Ending 30.06.23
Oil	-4.9
Gold	-3.3

MARKETS

International equity markets showed a steady performance over the last quarter, led by the USA, but there was a significant disparity of performance between different markets. Given the unsettled geopolitical and economic background, this must be considered a satisfactory outcome.

Looking at international equity markets firstly, in local currency terms the total return on the FTSE All World Index was +6.7%, in sterling terms +3.4%, in US dollar terms +6.3% and in euro terms +5.8%. In local currency terms, the stand out performer was the FTSE Japan Index, +15.0%, followed by the FTSE All World Latin American Index, +9.3%, and the FTSE USA Index, +8.7%. At the other end of the table, but still marginally positive, was the FTSE All World Asia Pacific ex Japan Index, +0.2%, and the FTSE UK Index, which was unchanged. However, the picture changes in sterling terms. From being a significant outperformer in local currency terms, the FTSE Japan Index, +3.0%, slightly underperformed the FTSE All World Index. The FTSE All World Latin American Index improved its relative performance in sterling terms at +11.5%. The FTSE USA Index continued to outperform the FTSE All World Index, returning +5.7%. Negative sterling adjusted performances were seen from the FTSE All World Asia Pacific ex Japan Index, -3.2%, the FTSE Australia Index -2.3% and the FTSE All World All Emerging Markets Index -1.9%.

For international bond markets, it was a difficult quarter, none more so than for the UK government bond market which was a significant underperformer. Taking 10 year government benchmark bond yields, the gross redemption on the UK bond increased by 90 basis points to 4.38%, on the US Treasury bond by 37 basis points to 3.84%, on the German Bund by 10 basis points to 2.39% and on the Japanese Government bond by 7 basis points to 0.39%.

The feature of the foreign exchange markets was the strength of sterling. Against the yen it rose by 11.9%, against the Australian dollar by 3.3%, against the US dollar by 3.0%, against the euro by 2.3%, against the Canadian dollar by 0.9% and against the Swiss Franc by 0.7%.

In commodity markets, oil, as measured by Brent crude fell by 4.9%, whilst gold declined by 3.3%.

ECONOMICS

The quarter ends on a downbeat note as investors' previous hopes that we may be near the peak of the current interest rate cycle have been dampened by some still stubborn inflation figures and positive economic data which have been reflected in some quite hawkish statements from central bankers. Central bankers have been subject to strong criticism for allowing the current situation to develop on the basis that they were far too complacent about the threat of rising inflation in 2021 and did not act quickly enough to tighten monetary policy. Of course, they cannot be blamed for the additional inflationary consequences arising from Russia's attack on Ukraine, but the inflation resulting from this event built on the pressures arising from too lax a monetary policy in 2021 and the early part of 2022 before the invasion took place. Central banks' view of inflation in 2021 as "transitory", because it reflected supply chain problems resulting from Covid which would unwind, looked complacent at the time and it certainly does now. Hindsight is a wonderful thing, but many economists were incredulous at central banks' complacency and we certainly echoed this viewpoint in our 2021 economic reviews. Once the inflationary genie has been let out of the bottle, it is very hard to put it back in, as we are now seeing.

Central bankers and economists tend to concentrate their attention on core inflation rates, those which exclude volatile items like food and energy. The figures are not looking pretty at the moment, even if headline rates are falling in some countries, and this is what is informing central bankers' monetary policy at present. Below is a selection of core inflation rates at the time of writing :

	%
UK	7.1
USA	5.3
Germany	5.8
France	5.8
Italy	5.6
Japan	3.2
Canada	3.7
Spain	5.9
Netherlands	6.9
Australia	6.6
Euro area	5.4
China	0.6

Given that inflation targets are normally around 2%, the gap between this level and core rates is large in most countries. The concern for central bankers is that high levels of inflation become embedded in people's expectations and drive pay demands. For central banks and governments, the trade off between inflation and recession with its resulting effect on employment levels is an unpalatable one. Central bankers will make the decisions on interest rates but politicians will suffer the consequences, so for governments in power around the world at this time this is not a comfortable time. For central bankers, much further from the electorate's political firing line, they are more likely to place the emphasis on bearing down on inflation. Now that inflation has escaped their targets by a large margin, the medicine in the form of rising policy rates and Quantitative Tightening (QT) will be more unpleasant. This seems to be the direction in which central banks are travelling.

Government bond yields are telling an interesting story, with a downward sloping yield curve between 2 year and 10 year maturities and then almost flat between 10 year and 30 year maturities. As this is written, this is the pattern of yields in the UK, US and German markets. The Japanese bond market is excluded because of the Bank of Japan's idiosyncratic monetary policy. It has a conventional upward sloping yield curve.

Gross Redemption Yields %

	2 year	5 year	10 year	30 year
UK	5.38	4.83	4.66	4.70
USA	4.94	3.34	4.05	4.04
Germany	3.23	2.72	2.63	2.62
Japan	- 0.05	0.09	0.43	1.26

The steepness of the downward slope of the yield curve between 2 year and 5 year maturities (Japan excluded) is very pronounced and this extends to 10 year maturities as well. Economists will say that this portends a recession on the basis that lower 5 year and 10 year maturities suggests that investors believe that a recession will occur, necessitating central banks having to reduce interest rates. If central banks' concern about sticky core inflation results in higher terminal short term interest rates than investors had previously factored in then clearly the chances of a recession increase. But there is one point to make here which does not receive sufficient attention. Rising interest rates are going to hit borrowers very hard, particularly those with mortgages when current low rates run off and have to be refinanced. There are a lot of savers who have suffered during the period of ultra low interest rates and they will get some of their purchasing power back. So rising interest rates are not bad for everyone and will provide some extra spending power to offset at least partly the hit for those affected by higher interest rates. An interesting item from Bloomberg derived from its analysis of data from the central bank indicates that UK households are on aggregate about £10 billion better off as a result of the rise in interest rates.

Q1 2023 growth rates, year on year, have been subdued. For the USA, growth was 1.6%, for Japan 1.3%, for the UK 0.2%, for Canada 2.2%, for France 0.9%, for Germany -0.5% and for Italy 1.9%, these relating to the G7 economies. For the euro area as a whole growth was 1.0%. India grew by 6.1% and China by 4.5%. There were some particularly disappointing annualised Q1 growth rates. For the euro area as a whole the figure was -0.4%, for Germany, -1.3%, for the Netherlands, -2.6%, a particularly poor figure. The UK managed to stay in positive territory, 0.5%, and the USA at 1.3%. But, with the lagged effect of rising interest rates still to be felt, these are not strong bases from which to project growth for the rest of the year, hence the nervousness in markets about a possible recession.

It is not, however, all gloom. Unemployment rates in a number of countries remain relatively low, for example, in the USA, 3.7%, the UK, 3.8% and the euro area, 6.5%, the latter high by the standards of the first two countries but much lower than it was. Some areas of spending have been noticeably strong, travel for example. The Paris Air Show has just ended with substantial aircraft orders placed for aircraft deliveries well into the future, in some cases post 2030, pointing to some confidence. Airlines have been caught off guard by the comeback in travel which has left some airlines short of capacity now to meet their immediate needs but which has given them confidence to book scarce delivery slots well into the future. Involuntary savings built up during lockdown and some of this is now being released, for travel for example, in apparent contradiction to current difficult economic times.

Monetary policy operates with lags so the world economy has not yet felt the full effects of the sharp and sudden rises in interest rates. Company profits are holding up well and dividends are tending to move upwards and these factors have provided some support to international equities against such an uncertain geopolitical and economic background. As clients will know, we have been very negative on fixed interest securities for a long time on the basis that extreme monetary policy had rendered price discovery useless and that yields bore no relation to reality and this has proved to be the case. For example, as we look at the UK 10 year government bond yield, now at around 4.66% at the time of writing, it is hard to believe that in 2020, admittedly in the uncertain times at the start of the Covid pandemic, the gross redemption yield got down to around 0.1%. It was clear that supposedly safe assets like government bonds were anything but safe at prices like that and so it has proved. What was also clear was that equities looked better value and less risky from a price perspective, even in 2020, because they were clearly not so obviously overvalued. The dividend yields on equities nearly everywhere far exceeded those on fixed interest securities. They also, of course, far exceeded the yield on cash, which in some countries was negative. There was, therefore, a strong case for saying that, at the very worst, equities were less unattractive than those other two asset classes and, at best, offered value on the basis that the world economy would recover and company profits and dividends with them. It was almost certain that holders of most maturities of fixed interest securities would suffer significant negative returns once there was a move back towards more conventional monetary policy and this was what happened. What was not known then in 2020 was that central banks would make a serious policy error in not recognising that rising inflation in 2021 was more than transitory and then that Russia would invade Ukraine in 2022 with negative knock on effects or inflation.

So, the sharp rise in bond yields and bank deposit rates now poses a stronger challenge to equities, which they did not do in 2020, and investors like us, who have felt that international equities were a far better home for clients' cash. That has been true so far, but it does not mean that it will be in the future. If we look at the relationship between the dividend yield on a particular market and the 10 year government bond yield, the relationship is less attractive for the USA, where the S & P 500 has a dividend yield of 1.57%, well below the 10 year US Treasury bond yield of 4.050%. For the UK it has also become more challenging, with the FTSE 100 dividend yield being about 30 basis points below the 10 year UK gilt. In Europe, dividend yields are generally higher than 10 year bond yields, although with a much smaller gap than previously. If we look at the earnings yield on the S & P 500, the reciprocal of the price/earnings ratio, for this year's expected earnings, it is around 5%, well above the 10 year US Treasury yield of 4.05%. It depends upon which maturity investors like to use, so, if the 2 year US Treasury yield of 4.94% is used, the earnings yield is only a little higher and it provides more of a valuation difficulty. Whichever way one looks at it, the sharp rise in interest rates provides more of a challenge to equities than it did. However, there are other factors to consider. One is that high quality bonds, like those issued by governments, still offer negative real yields and with sticky core inflation rates, detailed earlier, that situation may continue, unless there is a rise in nominal yields and, therefore, a fall in prices. Secondly, the supply side is unfavourable for the market. Governments, nearly everywhere, are running substantial budget deficits which have to be financed and, where central banks are involved in QT, like the USA, UK and ECB, there will be a further supply of bonds for markets to absorb. The combination of slowing economic growth, or possibly a recession, and monetary tightening is an unusual one. Normally, one would expect to see monetary easing to offset economic weakness but the rise in inflation has not allowed this to happen and because central banks failed to take the required action in 2021 to raise interest rates, the inflationary effects of the Russian attack on Ukraine could not be contained. Now, with a serious inflation problem to deal with, it seems, and there was not really any option, as if the threat of recession is considered a lesser evil than inflation. In normal circumstances, at the stage of the cycle, bonds could be expected to benefit from monetary policy action to stimulate the economy. Inflation and the vast supply of bonds coming on to the market rule this out on this occasion.

Cash, as an asset class, as opposed to being held opportunistically, or for short and medium term foreseeable needs, does have an advantage over fixed interest securities in that, if we are right in believing that bond yields have further to rise, at least the nominal, if not the real value, will remain unchanged. Of course, if everything else looked worse, there would be a relative attraction, but we do not think that we are there yet.

As a store of value in troubled times, gold is supposed to come into its own and, up to early May, that rationale appeared to have some reality as the price rose to over US$2,000 per ounce, but it has since fallen back quite significantly. Central banks have been notable buyers and being seen as a hedge against inflation is one of its perceived attractions. However, given its lack of yield, the sharp rise in interest rates means a significant opportunity cost for holders. It has never been one of the mainstream assets in our client portfolios and we see no compelling reason to change our view.

Property, a favourite for many investors, comes in many forms for investment but some generalisations can be made. Often bought for its sometimes attractive yield, the rise in interest rates has clearly been a negative factor. For "buy to let" investors, the combination of rising interest rates and a political background which is often not favourable to such investors in terms of the tax treatment of the asset and, in some places, rent controls, it has been a tough time and some are withdrawing from the market. Retail property has suffered from the move to online shopping, whilst offices are being affected by more people working from home, thus reducing the need for space. Even industrial property, recently one of the favoured parts of the industry because of the increase in online purchasing, has become more problematical as concerns about overcapacity increase. These are, of course, all broad generalisations and some niche areas of the market will remain appealing but, broadly, as a protection against inflation there are, in our view, too many negative headwinds blowing in the current environment.

Equities form the main asset class in our clients' portfolios. This is because we have believed for a long time that they offer the prospect of the best long term returns. Against a different background, we might have a significant fixed interest content. Our policies are flexible and relate to the circumstances and prospects as we see them.

We look at the different asset classes against the economic and political background at the time, to see if valuations reflect the realities of the situation. During the pandemic, economics formed the centrepiece of our framework as governments around the world, together with central banks, fought to stabilise their economies. So, fiscal and monetary policy was aimed at doing just this and policymaking, defined by political considerations, took the back seat. But this is now changing, in our view, and merits more input into investment policy. As often happens during difficult economic times, like the present, politicians, with their much shorter time horizon, look for scapegoats, which are usually businesses and an easy target. This is not a costless development. It has an effect on economic and investment sentiment towards a particular country and, by depressing share prices relative to what they might have stood at in the absence of political pressure, raises the cost of capital for business, with negative knock on economic effects, for instance capital investment. In many countries, because of the difficult inflation position, anti business and, by extension, anti wealth sentiment is on the rise. This is not healthy for investors or economies.

The UK is a good example, but other countries would be equally relevant, including the USA which we will discuss shortly. In the UK, although employment levels have held up relatively well, inflation has been particularly painful. As discussed earlier, the Bank of England, like other central banks, must take a big responsibility for this by failing to see inflation as the problem it threatened to become in 2021. Politicians are diverting some of the blame for the current inflation problem on to their central banks, but that is unlikely to resonate with electorates around the world whose ire will be directed at governments. We are here talking about the economic and investment consequences of political decisions. We are not commenting on the correctness of any particular political decision. So, taking the UK, the government has, as elsewhere, been under political pressure over soaring energy prices, in this case brought on by the Russian war on Ukraine. Energy producers, some of whose profits have soared, have been in the firing line, although without a symmetrical approach from their critics who were silent when, for example, the oil companies suffered enormous losses during the Covid outbreak as demand collapsed. The Russian invasion of Ukraine brought to the fore the vast importance of energy security and not many people would find that a contentious statement. Short term political pressure led to the UK government imposing windfall taxes on the sector, with the highly predictable effect of making the North Sea a much less attractive investment proposition for energy companies. This could have been foreseen. Food prices have risen particularly sharply, so the government calls in supermarket executives to see what they will do about it. Banks are under pressure to pass on to savers higher interest rates quickly.

Just to emphasise that we are not making political judgements, rather to point out the inevitable negative investment and economic consequences of such actions. Types of actions like these are a negative for the UK market. Another area of concern in the UK is the emergence of an activist regulator in the UK in the form of the Competition and Markets Authority ("CMA"). Particularly in the area of the technology sector, one which the UK government wants to emphasise and attract in the post Brexit era, it is important to send out positive signals about the UK. These seem to have passed by the CMA. A highly controversial decision was made to block Microsoft's acquisition of Activision Blizzard, a deal which even the activist EC cleared, although the FTC in the USA, another activist regulator, is trying to block it. Whether the CMA is right or wrong, the message it is sending out to investors is negative. The UK government appears to be concerned, indicating that the CMA should perhaps take into account wider issues such as the attraction of the UK as a technology hub. With a General Election due within 18 months at the latest in the UK, the anti business mood and unhelpful actions are unlikely to disappear.

Elections are also on the horizon in the USA, in this case November 2024, and these will also be important for markets. Because of the checks and balances in the US Constitution, Presidential economic influence is limited by his ability to get his measures through Congress, which is split at the moment with the Senate held by the Democrats and the House of Representatives by the Republicans. The budget put forward by the President for 2023, which will not be put into effect because the House of Representatives will not pass it, contains measures which can be called anti business and anti wealth. These include a sharp rise in company taxation and a hefty 4% charge on share buybacks which have been an important source of support for US equities. For the rich, significant tax increases were proposed. Now, these are not going to happen this side of the elections so some certainty up until then is good news for investors. However, depending on the results of the Presidential and Congressional elections next year, will be the relative attraction or otherwise of the US markets. For the moment, the USA looks a safer bet than the UK on political grounds. However, the USA also has activist regulators, some put in place by the President to further his agenda. Increasingly focused on the technology and healthcare sectors, the FTC and Department of Justice are trying to thwart deals, including, as mentioned above, Microsoft's bid for Activision Blizzard which Microsoft is seeking to overturn. One suspects that the courts might overturn some of the decisions of the regulators on grounds that there was no precedent for the arguments that the regulators have given. It remains to be seen, but this is an issue for investors in the USA, if not yet overtaking in importance the issues raised by the type of proposals for tax put forward by the President in his 2023 budget.

One market in which we don't invest directly is China, a particularly unprofitable market so far this year. However, it is illustrative of markets where political influences come to bear on performance. A lot of foreign investors are pulling out of China or reducing their exposure. There are obvious reasons for this but focusing on the political side as it affects shareholders, it is more clear than ever that Chinese companies exist for the state rather than shareholders and the "common prosperity" policy means that action can be taken against individuals and companies which severely damage shareholders' interests without any proper rationale. With the type of uncertainty which investors face in China, a big discount against other markets is necessary because shares cannot be evaluated the same way. China is the most extreme example of the way in which political uncertainty can adversely affect market ratings.

The political issues for different markets are becoming more important but in the context of evaluating the various investment options, we have to acknowledge that the rise in interest rates has posed a significant challenge to equities in terms of dividend and earnings yields against bond and cash deposit yields. Although international equity markets have performed creditably so far this year, it does seem harder going for markets at present as the timing of the move to and level of terminal interest rate peaks becomes more uncertain. Whilst the attraction of 2 year UK government bond yields of over 5% has received much attention, simply because that level of interest rates has not been obtainable for many years, it is still a negative real return given current inflation levels. We have highlighted particular issues for the UK market and, although it looks cheap compared with many others, there are reasons for this, one being the profile of the large UK based companies (i.e. not technology) and another being the particular issues we raised above. Apart from these, the UK government's enormous borrowing requirement could put further upward pressure on interest rates besides central bank administered rises and the effect of QT. We believe that sterling based portfolios should remain diversified through substantial overseas exposure. The international outlook for company earnings and dividends, whilst not strong, is not weak either and provides more substance as the base for capital growth as the world economy recovers from its present weak spell.

Realistically, it is likely to be a bumpy ride for investors as central banks continue to tighten monetary policy and before it becomes more apparent when the terminal level of interest rates will be reached. Long term equity investors should not be put off by this expected pattern of performance as the opportunity cost of holding significant cash is likely to be high when markets feel more confident and move ahead decisively.