meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equity markets have got off to a strong start in 2024 with very satisfactory returns being posted. As in 2023, the giant US technology stocks have led the way and a more optimistic feeling about the course of inflation and interest rates has helped to fuel the rise. Bonds, however, have experienced a disappointing quarter. There have been some significant foreign exchange movements. Gold is around new highs and oil has been firm as a result of threats to the supply from the war in the Middle East and the loss of some Russian oil refineries from military action.

The tables below detail relevant movements in markets :

International Equities 29.12.23 - 29.03.24

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.4	+1.7	+0.8	+3.1
Finland	-1.1	-2.4	-3.3	-1.1
France	+8.3	+6.8	+5.9	+8.3
Germany	+9.6	+8.1	+7.1	+9.6
Hong Kong	-9.8	-9.2	-10.1	-8.0
Italy	+16.1	+14.6	+13.6	+16.1
Japan	+18.7	+11.6	+10.6	+13.1
Netherlands	+17.9	+16.3	+15.3	+17.9
Spain	+10.3	+8.9	+7.9	+10.3
Switzerland	+6.0	N/C	-0.9	+1.3
UK	+4.6	+4.6	+3.6	+6.0
USA	+10.3	+11.3	+10.3	+12.9
All World Europe ex UK	+9.6	+6.9	+5.9	+8.3
All World Asia Pacific ex Japan	+4.5	+3.0	+2.0	+4.4
All World Asia Pacific	+9.3	+6.0	+5.0	+7.4
All World Latin America	-2.1	-3.0	-3.9	-1.7
All World All Emerging Markets	+4.2	+3.4	+2.4	+4.8
All World	+9.5	+9.1	+8.1	+10.6

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -1.6%

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

Currency	29.12.23	29.03.24
Sterling	3.52	3.93
US Dollar	3.88	4.20
Yen	0.60	0.72
Germany (Euro)	2.02	2.30

Sterling's performance during the quarter ending 29.03.24 (%)

Currency	Quarter Ending 29.03.24
US Dollar	-0.8
Canadian Dollar	+1.3
Yen	+6.4
Euro	+1.4
Swiss Franc	+6.3
Australian Dollar	+3.6

Other currency movements during the quarter ending 29.03.24 (%)

Currency	Quarter Ending 29.03.24
US Dollar / Canadian Dollar	+2.2
US Dollar / Yen	+7.3
US Dollar / Euro	+2.3
Swiss Franc / Euro	-4.5
Euro / Yen	+4.9

Significant Commodities (US dollar terms) 29.12.23 - 29.03.24 (%)

Currency	Quarter Ending 29.03.24
Oil	+13.0
Gold	+7.3

MARKETS

Q1 2024 has been a good one for international equity investors but less so for bond investors. In local currency terms, the FTSE All World Index has returned +9.5%, in sterling terms +9.1%, in US dollar terms +8.1% and, in euro terms, +10.6%. Looking at local currency returns firstly, the outstanding performer was the FTSE Japan Index which returned +18.7%. The FTSE USA Index showed a slightly above average performance, returning +10.3%. The weakest performers were the FTSE Hong Kong Index, -9.8%, and the FTSE All World Latin America Index, -2.1%. There were sub-average performances, but still good ones, from the FTSE All World All Emerging Markets Index, +4.2%, the FTSE All World Asia Pacific ex Japan Index, +4.5%, the FTSE UK Index, +4.6%, and the FTSE Australia Index, +5.4%. Turning to sterling adjusted returns, the FTSE Japan Index still led the field, returning +11.6%, and the FTSE USA Index still retained its relative outperformance, returning +11.3%. The FTSE All World Latin America Index and the FTSE Hong Kong Index also retained their negative performances with returns of -3.0% and -9.2% respectively and the underperformances, although with positive returns, remained the same as above, joined by the FTSE All World Europe ex UK Index, +6.9%. It should be emphasised, however, that these indices still showed a performance, which in most circumstances, would be considered satisfactory to good.

On the other hand, fixed interest markets showed a different picture. Taking ten year government bonds as the benchmark, we saw an upward movement in yields. The gross redemption yield on the UK government bond rose by 41 basis points to 3.93%, on the US Treasury bond by 32 basis points to 4.20%, on the Japanese government bond by 12 basis points to 0.72% and on the German Bund by 28 basis points to 2.30%.

There were some significant movements in the foreign exchange markets. Against the US dollar, sterling fell by 0.8%, but elsewhere it was stronger. Against the yen, it rose by 6.4%, against an unusually weak Swiss Franc, caused by a surprise interest rate cut, by 6.3%, against the Australian dollar by 3.6%, against the euro by 1.4% and against the Canadian dollar by 1.3%.

In the commodity markets, oil, as measured by Brent crude, rose by 13.0%, partly as a result of the destruction of some Russian oil refineries causing some supply concerns as well as continuing Middle Eastern uncertainty, whilst gold rose by 7.3%.

ECONOMICS

The paradox continues in Q1 2024 with a strong rise in many equitiy markets running in tandem with a very unsettled geopolitical situation and continuing economic uncertainties. There is no doubt that many investors and stock market commentators have been caught off guard by market movements so far in 2024. Of course, markets look ahead and try to discount what they feel they confidently can. That being the case, what can investors feel they are in a position to incorporate with as much certainty as possible into their investment thinking and strategy?

The answer to the geopolitical question is not much. The Ukraine/Russia war seems as intractable as ever and nobody knows how it will end. Markets are unfeeling and can appear callous at times. The brutality and suffering caused by this war are not what markets consider, rather it is the economic consequences which, after the initial disruption to supply chains, especially food and energy, are now settling down, with the spike in inflation which resulted now being replaced with a more benign outlook and countries have worked round the problems, at least for the moment. With a complete lack of clarity about the future course of this conflict, it is difficult to know whether markets are being complacent or not. One recent trend we can note is the rising price of fuel as Ukraine has successfully targeted a number of Russian oil refineries.

Uncertainty also prevails about the outcome of the Israel/Hamas war. Here, again, markets are completely unsentimental about another appalling human tragedy. Anything connected with the Middle East always raises fears about the oil supply and price. At the moment, this is not a significant issue, but attacks by Houthi rebels on Red Sea shipping could also feed through to inflation as ships divert to safer but longer passages to their destination. It is impossible to know how this war will end although, for the moment, it is being contained.

In the background, there is always the China/Taiwan stand off. China has become increasingly assertive and, for many observers, an invasion of Taiwan by China is a realistic possibility, although it is a non trivial one. It doesn't feel as if it is imminent but, if it happened, the implications would be much greater and more far reaching than the above very serious wars now taking place, since an invasion could bring the USA and other countries into the war, for that is what is would be. However, at the moment, this is pure speculation and one cannot base an investment strategy on possible future serious events occurring, otherwise one would not invest at all and that, of course, given the historical performance of equities, would be a mistake.

So, as far as geopolitical events and speculation about future possible ones are concerned, one can say with a great degree of diffidence that investors have processed the implications of the current two major wars and parked the China/Taiwan stand off in the background. Only time will tell but, on the basis that there are always reasons that can be put forward for not investing in the market or deferring doing so and the resulting opportunity costs which this can bring, we do not feel, on the evidence available, that investors have taken an unreasonable view about the consequences of these wars.

This leaves the economic outlook and, here, investors have certainly been taking the glass half full rather than the half empty view. First, though, we need to take a step back and look at the performance of international equity markets in 2023. They showed a positive performance at a time when interest rates had continued to rise. Many investors would not have expected this to happen but what helped to push equity markets higher was the excitement around AI and its implications, not only for those companies involved directly or indirectly in AI but for economies generally. So, Wall Street saw shares powering ahead led by the "Magnificent Seven". However, this rise was very concentrated in this small number of stocks. The total return on the S & P 500 Index in 2023 was 26.26% and on the S & P 500 Equal Weighted Index 13.87%. If one removed the "Magnificent Seven" from the Equal Weighted Index, the return on the rest of the S & P 500 Index would have been much lower still. The trend has continued into 2024 with the S & P 500 Index considerably outperforming the S & P 500 Equal Weighted Index. The phenomenon of the "Magnificent Seven" explains why shares defied what might have been the expected performance last year. They appeared to be out of sync with expectations. Now, however, the outlook including, crucially, for interest rates, looks better and markets are reacting how one might expect by looking forward to better times, but they are doing that from a higher level than one might expect, as just described above.

So what is it that markets are looking forward to and reacting so positively to, at least for the moment? The simple answer is that the fall in inflation will lead to the start of a period of falling interest rates at a time of very modest, but not unsatisfactory, world economic growth, given the position from where we have come post Covid. To put this in perspective, we can look at the OECD Economic Outlook forecasts for world growth made in February. The OECD puts world growth for 2024 at 2.9% and for 2025 at 3.0%. For the USA, it sees growth of 2.1% this year and 1.7% next year. For the euro area, it sees growth of 0.6% this year, rising to 1.3% next year. This is a very low figure, dragged down by poor performances from Germany (0.3% then 1.1%), France (0.6% then 1.2%) and Italy (0.7% and 1.2%). For the UK, the figures are 0.7% and 1.2%. For Japan, both years are shown at 1.0%. So, for the G7 countries, the figures are held up by the USA. The USA has defied expectations that the rise in interest rates would dampen economic growth or hit unemployment. The labour market is tight, as it is in the UK. This economic cycle is unusual in that respect. Up at the top of the table for growth expectations, are India (6.2% this year then 6.5%) and Indonesia (5.1% then 5.2%). Then comes China (4.7% and 4.2%), which is finding recovery from the Covid lockdown difficult. The disparity between China's and India's growth prospects is quite startling, with China having many more economic problems, the property sector being one of the country's major headaches. Whilst more or less equal in terms of population, India's economy is around US$3.5 trillion and China's is $17.8 trillion. By historical standards, these growth rates are unremarkable and, in a number of cases, disappointing, but, provided inflationary pressures are constrained, do give central banks a rationale for starting to reverse their interest rates increases and it is this prospect, together with AI fever, which is driving the rise in equity markets at present. Latest inflation rates are 3.2% for the USA, 3.4% for the UK, 2.4% for the euro area. Within the latter, the rate for Germany is 2.2%, for France 2.3%, for Italy 1.3% and for Spain 3.2%. For most central banks the target is around 2% and it is this "last mile", as it is sometimes called, which is the most difficult to achieve. If we look at those same OECD forecasts for 2024, it projects US inflation at 2.2%, the UK at 2.8%, the euro area at 2.6% and, within the euro area, Germany at 2.6%, France at 2.7%, Italy at 1.8% and Spain at 3.3%. So you would say that the "last mile" could prove difficult if the OECD's projections are accurate. The main issue for the US, UK and eurozone central banks is how sticky wages will be, in other words will they react to the more benign inflation outlook or remain anchored to the elevated inflation levels which we have seen. The US Federal Reserve has been more explicit in signalling some cuts in interest rates this year; the Bank of England and the ECB have been more cautious. What we can reasonably say is that it is probable, though not absolutely certain, that central banks have finished raising interest rates and, therefore, that the next movement is likely to be downwards. It is that which equity investors are focusing on because, in those circumstances, equities can be expected to perform well. However, that would normally be from a market level which had been lowered by previous central bank tightening. Equity markets were weaker in 2022 but, for reasons mentioned earlier, namely the AI frenzy, they reversed course in 2023 even as interest rates were rising.

This does not mean that we have changed our mind on the attractions of the bond markets. They have obviously undergone a painful and overdue correction from their seriously overvalued levels at the time of extreme monetary easing and, in that respect, are less expensive than they were with the relationship between yields and inflation much more realistic. However, there are some eye watering budget deficits around, with the USA particularly catching one's attention. The USA's Congressional Budget Office ("CBO") projects budget deficits on current policies of over 5% and moving to well over 6% as far as the eye can see. The primary deficits, which exclude interest payments, will average well over 2%, showing a significant structural problem. These deficits cannot be ignored for there could come a time when investors will demand higher interest rates, even though it is the USA and the US dollar is the largest reserve currency. There is a school of thought which believes that the size of the budget deficit does not matter in terms of the interest rates which the US or any other government has to pay but, intuitively, it does feel that, when one is talking of deficits this size, and not temporary ones at that, such complacency is misplaced. Whilst not many countries have budget deficits of this size, it is a general issue which detracts from the case for fixed interest securities, even if the inflation background is more benign than it has been recently. To underline the seriousness of debt levels, a new analysis from the IMF staff said that the average debt ratio in rich countries was on course to hit 120% by 2028, compared with about 75.4% at the start of the century. The blog, written by three senior officials of the IMF, said that governments would be stuck with permanently higher borrowing costs in the coming decades as they increased public spending and maintained interest rates far higher than they had been for 20 years. To our way of thinking, current bond yields do not properly reflect the risks which such elevated borrowing needs pose to this asset class.

The absence of compelling alternatives to equities, such as bonds or cash, and a background which is manageable in terms of risks for equities, leads us to continue to favour the latter class. Of course, the mandate would have to recognise equity risks but, in recent years, we have felt that the greater price risk lay with fixed interest markets because of the artificial suppression of interest rates through the extreme monetary policies which were being followed by central banks. Providing the geopolitical background does not turn even more ugly, in other words events occur which we cannot presently foresee, the economic background looks manageable, if not inspiring, for equities.

However, as we have said in years gone by, politics can be as important as economics in determining the attraction of various asset classes. This element of our thinking took a back seat during Covid as governments and central banks struggled to keep their countries' economies afloat. Now we are moving towards a semblance of economic normality, although still with a long way to go, we must turn our attention to the political outlook. We must say immediately that we do not take sides in political arguments, but what we must do as an investment manager is to point to consequences for stock markets of different political actions or policies.

There are about 40 elections this year, some more consequential than others. One of the important ones was in Taiwan with the ever present threat from China to annex it. With the more hawkish of the two main parties, the Democratic Progressive Party ("DPP"), retaining the Presidency, and though losing its majority in the legislature, the result ratcheted up tensions still further. The threat of a Chinese invasion, with all the unpredictable geopolitical consequences, is one reason some foreign institutions regard China as uninvestable, although there are other very important reasons. This is perhaps the most high profile case of politics having a significant influence on investors' attitude to investing in particular markets. In other important markets, the influence of politics on investors' decision making is not as extreme as the case of China, but nevertheless exists.

As touched upon above, as a firm, we do not make political pronouncements in our reviews, but what we do do is give an opinion on what policies and politicians' attitudes can mean to markets, positively or negatively, thus shaping our investment policy. Nowhere is this more important than in the USA, so the Presidential and Congressional elections this coming November will be very meaningful for investors. Inevitably, the Presidential election is focusing on the two likely candidates and the personalities involved. It is easy to see why many people focus on the personalities but a football or cricket analogy here is relevant and that is investors should play the ball and not the man. In other words, they should forget who is tackling you at football or bowling to you at cricket and play the situation on its merits, ignoring the reputation of your opponent. So, in politics look at the policies, not who is originating them. There is one further point about the US elections. Many people tend to concentrate on who wins the Presidential election, and this is understandable, but they should be looking at the results in the two Houses of Congress, which are currently split, with the Democrats holding the Senate and the Republicans the House of Representatives. This means that there is legislative stalemate at the moment and President Biden's 2023 budget proposals focusing on higher corporate and, for some, personal taxes have not come about. In his recent State of the Union address, President Biden again emphasised plans for higher corporate taxes and the same for higher income earners. These are significant. Among a slew of measures for 2025 would be an increase in the corporate tax rate to 28% and a 4% tax on share buybacks, compared to 1% at present. There were many more proposals, but the direction of travel is one which would be likely to decrease the attractions of US equities and is quite extreme by US standards. Stock buybacks have been very supportive of the US equity market. A 4% tax would be a strong disincentive to stock buybacks which, although dividing opinion, undoubtedly have helped to provide some of the reasons behind the strong stock market performance. Whether or not these, and the many other measures, come to fruition will depend on the Congressional election results in November, so investors should take careful note of the likely results. On the other hand, Donald Trump's renewed support for tariffs, a baseline 10% on all US imports and a levy of 60% or higher on imported Chinese products, would also have negative implications for the US and world economy, negating the advantages which free trade have brought and, in the short term, raising inflation. His views may change but, whatever one's views on tariffs on imported goods, the measures would be unlikely to be positive for investors in US or other countries' securities. Given that the USA is our largest area of equity asset allocation, we are monitoring developments in US politics. At the moment, given the strength of the US equity market, it is not an issue upon which investors appear to be concentrating.

But there is one further issue upon which we are increasingly concentrating, as we feel it is a market issue, and this is the effects of increasing regulation, especially in the area of competition. Excessive regulation, in whatever field, is a dead weight on an economy. Europe, of course, is a prime example of this and probably a reason why its productivity record is poor compared with that of the USA. The UK, of course, also suffers from low productivity growth. A blizzard of regulation is facing EU members again, causing serious complaints from companies about the cost to them. Farmers, too, are becoming militant in the face of green measures which affect them.

For the moment, however, we are concentrating on the competition regulations. It is often wondered why Europe has been far less successful than the USA in fostering the high tech industry. One reason is that, rightly or wrongly, it is perceived that Europe is hostile to high tech and that mainly means US firms. The EU's Digital Markets Act has just come into force for those companies which have been designated. Without passing judgement on the rights or wrongs of the case, the EU's recent announcement, timed around the Digital Markets Act, of investigations into Meta, Apple and Alphabet (the owner of Google) for uncompetitive practices, was announced with a certain relish. It is not a good look for Europe as far as investors are concerned because it suggests, rightly or wrongly, a certain hostility to business and entrepreneurs and the technology sector in particular. The first order effect may be to deter foreign inward investment in the EU and the second order effect may be to influence the investment allocations of international stock market investors. In the UK, the Competition and Markets Authority has been aggressive in its approach to business combinations, with the technology sector seemingly in its cross hairs. At a time when the UK government is trying to promote the UK as an attractive venue for high tech companies, the CMA's actions appear to be in conflict with these objectives and there have been signs of government frustration at the regulator's approach. Again, the UK's attraction to investors is reduced by what some may feel is overbearing regulation. Whether or not regulators are right is not for us to say, but we can certainly see what it might do to the investment attractions of the UK. And, of course, the wider question is why the US equity market is rated so much more highly than those of the UK and Europe. One obvious answer is that the USA has far more highly rated technology companies, for example the "Magnificent Seven", which have been driving the US stock market. The USA is certainly a more entrepreneurial country, which has enabled these tech giants to develop to the size they have.

However, we also have to recognise that, whilst a President whose party does not have control of both Houses of Congress is limited in what he can do, say, in the field of tax, executive authority enables him to exercise indirect power through appointments to government agencies and similar. In this area, a more aggressive regulator has been taking aim at the high tech companies. In this respect, the recent announcement that the US Justice Department is suing Apple for monopolising smartphone markets shows that it is not just European regulators which have high tech companies in their sights. This case, which Apple will obviously fight, will take years to resolve and US companies can take some comfort from the fact that the courts may reach different decisions on appeal. Investors in US stocks in the sights of regulators must not be complacent. Political influences are apparent, though these may, of course, change over time. The airline industry also appears to be in the regulator's sights, with the proposed merger of two US airlines, outside the top four, JetBlue and Spirit blocked and ultimately abandoned. M & A activity does support equity markets and so a much stronger line on mergers becomes a market factor if pursued aggressively. This does not yet affect our view of the US market, but we remain mindful of the political and regulatory influences on the market.

Quite at random, and there are many other examples, it is instructive to note political and regulatory actions which may affect international direct investor attitudes towards a particular country or area and, by extension, to international investors' geographical asset allocation. If we look at the UK's windfall taxes on the energy sector, they appear to have made North Sea an almost uninvestable area for companies and still higher taxes are threatened. In the banking sector, we were struck by a statement by the Head of Santander UK who said the bank group should avoid "putting a lot more capital" into the UK because of the country's high tax burden and the rising bill for compensating victims of fraud. In Europe, Bloomberg carried a recent article titled "Populism is Scaring Away Big Business in the Netherlands". Whilst one of Dutch companies greatest concerns was restrictions on their ability to employ skilled people from abroad, in the investment world, recent laws to tax share buybacks and to reduce tax benefits for expatriates have caused serious concern about the attraction of the Netherlands as a business hub. The EU is, of course, well known for its high level of regulation and, for many observers, is a major reason why it has been less successful economically than the USA. In a new ramp up of regulations, companies have become very vocal in their opposition to a revised Product Liability Directive, with legislation passed in March. If a company or customer alleges a fault or injury from a product, the company facing the allegation must show that their product or service was not responsible. In other words, the burden of proof on manufacturers of physical and digital goods is reversed or, put simply, they are guilty unless proved innocent. Such legislation is typical of an anti business attitude prevalent in parts of the EU and this Directive has to be a negative factor for companies and, indirectly, investors in the EU. Finally, the USA where the President has instilled some activist regulators. In the area of competition, the anti trust case against Apple, one of the most successful companies ever, does not send a positive sign to investors. In the USA, there are many more pro business politicians who understand what is needed to create a successful economy, so the threat is not as great as in Europe. Whatever the rights and wrongs of the competition regulators' case, the message is not positive but, for the moment in the USA, it can be parked into the future as a potential stock market concern to note.

From the tables at the beginning of this review, it can be seen that Japan has been the outstanding performer over the last quarter, regaining new highs after many years since the previous peak. It has been a market which has often led to dashed expectations but investors have been encouraged by policy moves to improve corporate governance and to put more emphasis on shareholders through dividend increases and taking a less hostile view to M & A activity. Structural changes like these can be very beneficial and, at a time when there are reasons to be cautious, for the reasons given, about western European markets, Japan may continue to receive more investment attraction.

It would be unreasonable to expect equity markets to continue to rise at the pace of the first quarter of 2024, with so many uncertainties in the background, particularly on the geopolitical front. Quarterly setbacks are bound to occur against our central view that equity markets will continue to rise over time as a result of the expectations of continued world economic growth. As stated earlier, we still see bonds as lacking a compelling case, given the very poor budgetary and debt positions of many countries, the USA included. For us to abandon our current investment preference in investment portfolios for equities, we would have to expect some event so serious that the equity risk would be too great. Of course, there are always "unknown unknowns" to partially misquote Donald Rumsfeld, but one cannot have an investment policy which assumes the worst, otherwise one would not invest. We hope we are not being complacent in saying that investors are becoming used to unexpected and unforeseeable events occurring and are less inclined to abandon their long term investment policies but there is some evidence that this true.