meridian

ASSET MANAGEMENT (C.I.) LIMITED

# INVESTMENT MEMORANDUM

A quarter of little overall change in securities markets hides some significant moves within the three month period. That markets ended up little changed was due to a strong equity and bond rally in November as investors became more hopeful about the prospects for inflation and, therefore, interest rates. Currency movements were not significant although sterling did weaken modestly. Gold performed well.

The tables below detail relevant movements in markets:

## International Equities 31.08.23 - 30.11.23

| Total Return Performances ( % ) | | | | |
|---|---|---|---|---|
| **Country** | **Local Currency** | **£** | **US$** | **€** |
| Australia | -1.7 | +0.7 | +0.6 | +0.1 |
| Finland | +0.4 | +1.0 | +0.9 | +0.4 |
| France | -0.5 | +0.1 | N/C | -0.5 |
| Germany | +1.6 | +2.3 | +2.2 | +1.6 |
| Hong Kong | -6.9 | -6.4 | -6.5 | -7.0 |
| Italy | +4.4 | +5.0 | +4.9 | +4.4 |
| Japan | +2.8 | +1.4 | +1.3 | +0.7 |
| Netherlands | +2.7 | +3.4 | +3.3 | +2.7 |
| Spain | +7.1 | +7.7 | +7.6 | +7.1 |
| Switzerland | -3.0 | -1.3 | -1.4 | -2.0 |
| UK | +1.2 | +1.2 | +1.1 | +0.6 |
| USA | +2.0 | +2.1 | +2.0 | +1.4 |
| All World Europe ex UK | +1.1 | +2.0 | +1.9 | +1.4 |
| All World Asia Pacific ex Japan | -0.5 | +0.6 | +0.5 | N/C |
| All World Asia Pacific | +0.7 | +0.9 | +0.8 | +0.2 |
| All World Latin America | +7.4 | +6.6 | +6.5 | +6.0 |
| All World All Emerging Markets | +0.9 | +1.1 | +1.0 | +0.4 |
| All World | +1.6 | +1.8 | +1.7 | +1.2 |

*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 | 31.08.23 | 30.11.23 |
|---|---|---|
| Sterling | 4.36 | 4.17 |
| US Dollar | 4.11 | 4.33 |
| Yen | 0.65 | 0.67 |
| Germany (Euro) | 2.46 | 2.45 |

## Sterling's performance during the quarter ending 30.11.23 (%)

| Currency | Quarter Ending 30.11.23 |
|---|---|
| US Dollar | -0.3 |
| Canadian Dollar | N/C |
| Yen | +1.4 |
| Euro | -0.8 |
| Swiss Franc | -1.4 |
| Australian Dollar | -2.2 |

## Other currency movements during the quarter ending 30.11.23 (%)

| Currency | Quarter Ending 30.11.23 |
|---|---|
| US Dollar / Canadian Dollar | +0.3 |
| US Dollar / Yen | +1.9 |
| US Dollar / Euro | -0.5 |
| Swiss Franc / Euro | +0.4 |
| Euro / Yen | +2.3 |

## Significant Commodities (US dollar terms) 31.11.23 - 30.11.23 (%)

| Currency | Quarter Ending 30.11.23 |
|---|---|
| Oil | -5.4 |
| Gold | +6.1 |

## MARKETS

Despite volatility within the quarter, international equity markets ended little changed over the quarter as a whole. In local currency terms, the FTSE All World Index returned +1.6%, in local currency terms, +1.8% in sterling terms, +1.7% in US dollar terms and +1.2% in euro terms. The very small differences in currency returns show that currency movements were minor. Looking at local currency returns, the stand out performer was the FTSE All World Latin American Index, which returned +7.4%. There were negative performances from the FTSE Australia Index, -1.7%, and the FTSE All World Asia Pacific ex Japan Index, -0.5%. Back in sterling terms, however, both of these indices moved into positive territory with the FTSE Australia Index returning +0.7% and the FTSE All World Asia Pacific ex Japan Index returning +0.6%.

International bond markets recovered strongly from earlier weakness and the change in gross redemption yields was much less than in some previous quarters. Taking ten year government benchmark bonds, the gross redemption yield on the UK gilt fell by 19 basis points to 4.17%. On the US Treasury bond, it rose by 22 basis points to 4.33%. There was hardly any change in the German Bund yield, down just 1 basis point to 2.45%. The yield in the Japanese Government Bond rose by 2 basis points to 0.67%.

As suggested above, over the quarter as a whole there was little change in exchange rates, although the US dollar was weak at the end of the quarter. Sterling rose only against the yen, +1.4%, and was unchanged against the Canadian dollar, but it fell by 2.2% against the Australian dollar, by 1.4% against the Swiss Franc, by 0.8% against the euro and by 0.3% against the US dollar.

Despite the efforts of OPEC+ to support the oil price, as measured by Brent crude, it fell by 5.4%. However, gold showed notable strength, rising by 6.1%, therefore, at least in the short term, justifying its reputation as a store of value in uncertain times.

## ECONOMICS

And may you live in interesting times. At a linguistic stretch that could apply right now to mortgage holders whose payments have soared over the last two years but, more sensibly, these interesting times point towards events occurring around the globe. It has been suggested that these apparently warm words are nothing of the sort and that the origins may be a Chinese expression which can be translated as “Better to be a dog in times of tranquility than a human in times of chaos.” For those operating in government, the Foreign and Commonwealth Office or, at the extreme, the Ministry of Defence, uninteresting times would hold every attraction. In October Jamie Dimon, the highly regarded media-facing chief executive of American bank JPMorgan, was reporting strong results for the last quarter with high levels of interest helping the bottom line. Most notable, however, was his broader comment that this “may be the most dangerous time the world has seen for decades” and it’s not difficult to understand why he said it. We have two conflicts on the fringes of Europe that each centre on an invasion of another internationally recognised sovereign state but similarities between the two end there. The focus of this memorandum is not to draw conclusions about the rights or wrongs of such conflicts but, rather, to understand the economic consequences of unfolding events and gauge the rate and possible extent of economic change around the globe. The horrors committed and reported in both geographies are beyond words and such suffering is, tragically, measured in body counts and an escalation in venomous hatred towards perpetrators that will be handed down to future generations. For so many close to the epicentres, these are most definitely times of chaos.

The more established conflict of the two continues in Southern Ukraine and we are now eighteen months on from the invasion. Troops have dug in, mines have been laid and the fatigue and the attritional nature of each day saps morale but the Kremlin's resolve remains steadfast. The *force majeur* of the mild weather Europe enjoyed last winter came as a blow to Russia's strategic planning as it, presumably, hoped that its vital supplies of natural gas to the factories and homes of Europe would have been a trump card in its deck but it now looks like it has only succeeded in losing a reliable customer in its neighbourhood. Russia has increased supplies to China, India and others but the Kremlin's biggest customer is its own people, who consume gas and oil at heavily subsidised prices and then follows China, which typically pays around half of what Europe pays for piped gas. Europe has increased storage capacity, diversified away from gas and turned to sellers of sea-borne liquified natural gas. In September, Russia's state bank, VEB, estimated that pipeline natural gas exports to the European Union may fall to 21 billion cubic metres (bcm) in 2023, almost two thirds lower than last year and a more than six fold drop from 2021. Natural gas currently represents around a quarter of the EU's overall energy consumption and a quarter of the gas is used in power generation and a quarter in industry. Most of the rest is used in the residential and services sectors, mainly for heating buildings. VEB forecasts that exports to Europe will drop to 15bcm by 2026 while Russia would be unable to distribute the spare capacity to Asia due to infrastructure constraints.

This is representative of a central economic point, one which is more relevant now than at any time in the recent past, and that is the decades long shift towards globalisation, where every product or service is supplied by the country that is best placed to produce it – the law of comparative advantage, is at serious risk of unravelling as conflict, belligerence or policy translates into the twenty first century response of embargo, tariff or sanction. Now that trade is truly international and countries buy and sell goods bilaterally, measures taken against one country tend to lead to an antagonistic response. Russia, for reasons that are self-evident, is a country that has damaged its future economic prospects because of what might be called euphemistically its expansive foreign policy. For Europe, the cost of shipping in natural gas from the Middle East or United States plus the need to improve port and storage facilities creates economic inefficiencies. For Russia the revenue lost from piping less gas to Europe, using existing infrastructure that has been paid for, creates its own problems. War is expensive and suffering depleted tax revenue from reduced oil and gas exports is not helpful for President Putin, though he is, most likely, untroubled by the absence of sympathy from overseas. Again, at the risk of seeming to ignore the human cost within the theatre of war, the economic cost of these inefficiencies is sizeable and trickles down to the end user.

Moving on to a second example, the buzz around electric cars has led to big changes in the manufacture of cars, both where they are made and how they are made. If we consider the three leading markets for cars, the US, Europe and China, all see the problem from very different angles. In many ways Europe is the incumbent, with most to lose from change as it dominates the profitable high end of the market globally but the tectonic shift away from petrol and diesel presents risks to the status quo which China is seeking to exploit. The manufacture of cars in China is split into two. There are the non-Chinese manufacturers such as Volkswagen and there are the local manufacturers, some of which are directly or indirectly state owned. Increasingly, foreign manufacturers are adopting an 'In China, for China' policy and looking to other countries for new manufacturing bases. The Chinese producers have always been unable to match the brand prestige of, say, Audi or Mercedes and have focused on the new segment of fully electric cars, and with quite some success. Badging their exports by buying struggling European brands such as Volvo and MG has been one strategy employed. The established order has been disrupted by this and President Biden in his slightly oddly titled Inflation Reduction Act of 2022 has directed nearly $400 billion in federal funding to clean energy projects. Electricity generation and transmission enjoy the largest slice of the pie with electric vehicle (EV) incentives following in second. Chief amongst them is a subsidy available which is dependent on a local content threshold being met. Buyers can claim a tax break of up to $7,500 if they buy a car whose final assembly was in North America, with half of the tax break being reliant on the extraction of the constituent metals taking place in a country with which the U.S. has a free trade agreement. China, the E.U. and United Kingdom do not have such an agreement. E.U. exports to the U.S. of critical metals totalled €3.5 billion in 2022 according to Eurostat data. This is somewhat reminiscent of the Trump-era metals tariffs, another example of inefficiencies being introduced into the system through political will.

In October, the European Commission formally launched an anti-subsidy investigation into the importation of battery electric vehicles from China. The EC states that it has found evidence of loans at favourable rates, tax exemptions and components bought at below market prices. It is also noteworthy that this complaint is being brought by the European Commission itself rather than being in response to an industry complaint. The direction of travel in this trade triangle is worryingly predictable and intervention from governments, usually aiming to favour domestic interests over international ones, is, again, likely to harm the end user.

Moving to a country that is rarely mentioned in this memorandum, the increase in distrust between the U.S. and China is playing into the hands of Mexico. Well placed geographically and politically, Mexico's trade partnership with its northern neighbour is going from strength to strength and Mexico is now the largest trading partner of the U.S. measured by adding two way trade. The trend is clear, with exports from Mexico to the United States in 2022 up 18.9% over 2021 to $454.8 billion. This figure is 64% higher than it was in 2012. Going the other way, Mexico's imports from the United States were $324.3 billion in 2022, up 17.0% from 2021 and up 50% from 2012. Mexico's relationship with the US (and Canada) falls under the North American Free Trade Agreement which was enacted in 1994 and which led to the elimination of almost all tariffs and quotas on 1st January 2008. This was superseded by the United States-Mexico-Canada Agreement (USMCA) in 2020 but with all products that had zero tariffs under NAFTA still enjoying such treatment. This is bound to strengthen and embed trade relations and, if contrasted with increased trade friction as distrust of others grows, the momentum only increases. President Biden has inherited a level of tariffs imposed by his immediate predecessor which he needs to consider and being the biggest destination for most exporting countries puts him in a strong position.

Re-shoring is a term that is heard more and more for the process of shortening supply chains with more trusted countries being favoured over less trusted countries and the ingredient of trust is becoming increasingly relevant as we move through the 2020s. Processes of manufacture, within multi-year contracts involving an unknown number of sub-contractors are not easy to unwind and parties may even contribute to inertia but the extent of these chains may have reached their high water mark. Trump imposed tariffs on more than $300 billion of imports from China and the Biden administration has maintained them. Marginal advantage in these trade wars may fall to one country or the other but the war represents a loss of efficiency in economic terms overall. The economic and political tensions between the United States and China continue to build and the shift in trade volumes is starting to be noticed. There does not to appear to be much good reason to hope for reductions in tariffs between the two but deteriorating international diplomacy is easier to spot than improvement. The most contentious issue between the two at present is high end silicon chips and this is not about state-sponsored subsidy but simply what those chips might be used for and in which countries they might end up. If some of those chips were to end up in missiles landing in Ukraine, then there could be a very rapid worsening of the situation.

Quite clearly there are a number of red lines that could pre-empt a very rapid deterioration in global diplomacy and the most likely triggers would appear to be in the hands of China and Russia. Vladimir Putin has been absent from the world stage, such as G20 meetings, for fairly clear reasons but has managed to meet Xi Jinping twice in the last nine months, had two meetings with Kim Jong Un in September and most recently has, in his view, been playing his part in the Middle East peace process by welcoming Hamas and a senior Iranian envoy to Moscow.

Globalisation, like democracy, has its imperfections but has brought untold benefit. It has, as everyone agrees, been a tailwind overall. It has lowered costs as production has moved to lower cost countries. Those countries have benefitted from the investment and average incomes in those countries have risen. Consumers have benefitted from lower prices and quality is no longer shaped by any pre-conceived view of the country of origin as the power of branding has triumphed. Buying power has increased as inflation (until recently) has been suppressed and the speed at which emerging nations have increased their GDP per capita has accelerated. Whilst goods manufacturers will have to navigate around the politicians and the consequences they might create, certain markets are particularly vulnerable, such as the commodities market. Commodity markets are in some ways unusual because they cannot easily be shifted from one location to another and, in many, there is a ceiling to what can be produced. Ukraine is a good example of how the supply of oil, natural gas and cereals can be weaponised for political advantage. Scarcity of any commodity tends to lead to raised global prices which affect developing countries disproportionately. The October edition of the IMF's World Economic Outlook covers this theme in quite some depth and notes that the three largest producing countries account for 65% of the global output of agriculture, 50% of that of energy and about 70% of that of mineral commodities. Around 85% of the world's lithium is extracted in just three countries. The IMF report explores the scenario where the world is split into two political blocs, which it bases on the UN voting at the time of the invasion of Ukraine, arguing that trade tends to follow geopolitical allegiances.

With inflation being perhaps the largest economic threat for the past two years the risks associated with the so-called Balkanisation of the world cannot be ignored but at the same time all leaders realise it is not in their interest to make life for their people harder than it need be. All but the most extreme dictator maintains a watch over public sentiment within their borders. The invasion of Ukraine was an example where a political decision led to an abrupt change in the standing of a trading partner, namely Russia, and the scale of the economic backlash against the country must have surprised many within the Kremlin. Decisions about continuing to do business would have been considered carefully before pulling the plug, an example being the continuing purchase of Russian oil and gas, albeit at lower levels, despite it funding their war efforts. This begs the question what would happen if circumstances led to an equivalent breakdown in relations with China? The prospect of all non-Chinese companies having to withdraw from China as well as sanctions on Chinese exports with equivalent retaliatory measures would throw the world into a huge economic crisis with equity and bond markets crashing instantly. All sides would seek to avoid this, meaning that a more limited diplomatic and economic breakdown would most likely occur. The most probable cause of this happening would be an invasion of Taiwan and China has made its intentions very clear here. Taiwan would be supported in its defence by the United States.

China is the second largest economy in the world and is a country of 1.4 billion people. It feels that its presence on the world stage should not reflect the past but be shaped by its ambitious plans and its desire to influence. The Chinese Communist Party's approach to foreign policy appears to mimic its domestic policies in that it does not expect its actions to be challenged and the strength of its views grow in direct proportion to its economic might. There is a hierarchy of interest within their thinking and the goals of the party are implacable. At the bottom of their list would be those with competing interests.

The rise of China represents a change to the world order and, ergo, that means a loss of status to the incumbents. There is a diplomatic wariness towards China where, on one hand, the benefits of trade are currently unequalled but, on the other, China's rules of engagement are increasingly different. Companies seek access to the Chinese domestic market but increasingly do not wish to create regional hubs there. Companies can make choices around China as a market but it is hard to ignore the growing spending power of its consumers. The trick with China is to become a participant in its domestic market without getting involved in the politics but even this is getting increasingly difficult and new Chinese anti-espionage and data legislation, for example, makes a difficult job even harder.

The APEC summit in San Francisco in November was a good opportunity for Biden and Xi to air their views to each other and to demonstrate a willingness to cooperate. There was limited progress in real terms but encouraging words, particularly from Xi. He stated that it is wrong to see China as a threat and play a zero-sum game against it. If there's one thing that China needs at present it is direct foreign investment but the concern around doing business in the country was summed up at the beginning of the summer when the US Commerce Secretary commented that companies are describing China as "uninvestible". There is clearly a problem here but, despite what views may be held on China's leadership, its contribution to growth is not restricted to within its own borders and the wider economic effect of its growing consumption and the effect it has had on the supply side has had an inevitable wealth effect in the West.

Economic growth in developing countries has accompanied increased consumer spending power and developed countries have moved their economies towards the provision of services and high end goods as consumers pivot towards that pattern of spending. The arguments above highlight the risk that a continuing loss of trust caused by aggressive foreign policy or overly supportive domestic policy eventually has an effect on the global consumer. As is so often seen in economics situations arise which have precedents which bear some similarities but nothing more. At this time it is impossible to gauge the risks associated with a prolonged breakdown in world trade because it is not certain to what extent it will occur, if at all, and the economic effects would, most likely, be considered secondary to the political events which would have triggered the breakdown. The world has never been so interconnected and yet so vulnerable because of it.

Former US Secretary of Defence, Donald Rumsfeld, who through his two terms of office was both the youngest and oldest holder of the office, often showed a unique turn of phrase with, perhaps, his best known quote being his dissection of known and unknown knowns whilst recognising that unknown unknowns have their place. The context for his unknown unknowns was reference to the history of the US and other free countries tending to find them difficult. How best to invest for difficult times? It would seem to make sense to invest in assets that have a track record of strong inflation-adjusted returns over the long term, assets that are diversified and assets that have a track record of absorbing shocks and recovering and, accompanying that, accepting that the short term can often look less appealing than the longer term. The reader will infer that it is that it is difficult to offer a solution to an unknown problem but at the same time fear of unknown problems could make any decision making impossible. The last 15½ years, a period deliberately chosen to start at the highest market point immediately before the Great Financial Crisis until the end of November 2023, shows an annualised total return on the FTSE All-World index in sterling terms of 9.3%. Unknown unknowns have certainly featured in this period and remaining invested in equities throughout has been a very good strategy, albeit one that has, at times, tested the resolve of nearly every investor.

Markets are either capable of or guilty of disregarding the greatest risks facing the world economy and focusing on the more immediate. 2023, with a twelfth of the year yet to go, is shaping up to be a pretty good year for global equity markets where, if it could be summed up in the fewest possible words, it would be that inflation is responding to medicine without killing off growth. Referring to the previous paragraph, all portfolio holders are reminded of the constant and immediate threat that world events can pose and are advised to draw comfort from history. These are interesting times.