meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

This has been a strong quarter for international equity markets with none of the returns in our table below being negative. Good news on the vaccination front leading to raised expectations of economic recovery, together with supportive monetary and fiscal policy, have driven equity markets. What has been good for equity markets has not been so good for fixed interest markets, with fears of rising inflation spooking investors. In the foreign exchange markets, commodity influenced currencies, such as the Canadian and Australian dollars, strengthened, but against other major currencies sterling was firmer. Commodity prices rose over the quarter, with oil for example, as measured by Brent crude, increasing by 21%.

The tables below detail relevant movements in markets :

International Equities 29.01.21 - 30.04.21

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+7.9	+7.7	+8.6	+9.6
Finland	+8.2	+6.3	+7.2	+8.2
France	+15.3	+13.3	+14.2	+15.3
Germany	+11.0	+9.1	+10.0	+11.0
Hong Kong, China	+8.6	+7.5	+8.4	+9.4
Italy	+12.6	+10.6	+11.6	+12.6
Japan	+5.9	+0.6	+1.4	+2.4
Netherlands	+15.7	+13.7	+14.7	+15.7
Spain	+12.9	+11.0	+11.9	+12.9
Switzerland	+7.7	+4.2	+5.0	+6.0
UK	+10.2	+10.2	+11.1	+12.1
USA	+12.4	+11.5	+12.4	+13.4
All World Europe ex UK	+11.7	+9.4	+10.3	+11.3
All World Asia Pacific ex Japan	+2.9	+1.9	+2.7	+3.7
All World Asia Pacific	+3.9	+1.5	+2.3	+3.3
All World Latin America	+5.4	+5.2	+6.1	+7.0
All World All Emerging Markets	+2.3	+1.3	+2.1	+3.1
All World	+10.2	+9.0	+9.9	+10.9

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -5.1%

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

Currency	29.01.21	30.04.21
Sterling	0.33	0.84
US Dollar	1.07	1.63
Yen	0.05	0.09
Germany (Euro)	-0.52	-0.20

Sterling's performance during the quarter ending 30.04.21 (%)

Currency	Quarter Ending 30.04.21
US Dollar	+0.9
Canadian Dollar	-3.0
Yen	+5.3
Euro	+1.8
Swiss Franc	+3.4
Australian Dollar	-0.1

Other currency movements during the quarter ending 30.04.21 (%)

Currency	Quarter Ending 30.04.21
US Dollar / Canadian Dollar	-4.0
US Dollar / Yen	+4.4
US Dollar / Euro	+0.9
Swiss Franc / Euro	-1.6
Euro / Yen	+1.9

Significant Commodities (US dollar terms) 29.01.21 - 30.04.21 (%)

Currency	Quarter Ending 30.04.21
Oil	+21.0
Gold	-4.9

MARKETS

It has been a strong quarter for international equity markets and a poor one for international bond markets. The FTSE All World Index has returned +10.2% in local currency terms, +9.0% in sterling terms, +9.9% in US dollar terms and +10.9% in euro terms.

Looking at individual and regional markets in local currency terms, we note average or above average performances from the FTSE USA Index (+12.4%), the FTSE All World Europe ex UK Index (+11.7%) and the FTSE UK Index (+10.2%). Below average performances were seen from the FTSE All World Asia Pacific ex Japan Index (+2.9%), the FTSE All World All Emerging Markets Index (+2.3%), the FTSE All World Latin American Index (+5.4%) and the FTSE Japan Index (+5.9%). However, although these markets underperformed the FTSE All World Index, they still ended up in positive territory. Even though sterling appreciated over the quarter, there were no negative performances here either. The FTSE USA Index (+11.5%), the FTSE All World Europe ex UK Index (+9.4%) and the FTSE UK Index (+10.2%) all exceeded the sterling adjusted performance of the FTSE All World Index (+9.0%). The underperformers remained the FTSE Japan Index (+0.6%), the FTSE All World Asia Pacific ex Japan Index (+1.9%), the FTSE All World All Emerging Markets Index (+1.3%) and the FTSE All World Latin America Index (+5.2%).

Concerns about inflation affected international bond markets during the quarter. Taking ten year government bond benchmark yields, the gross redemption yield on the UK gilt rose by 51 basis points to 0.84%, on the US Treasury Bond by 56 basis points to 1.63%, on the Japanese Government Bond by 4 basis points to 0.09% and by 32 basis points to -0.20% on the German Bund.

As noted above, sterling strengthened over the quarter, falling only by 3.0% against the Canadian dollar and 0.1% against the Australian dollar. Against the yen, it rose by 5.3%, against the Swiss Franc by 3.4%, against the euro by 1.8% and against the US dollar by 0.9%.

In the commodity markets, oil, as measured by Brent crude, rose by 21.0%, but gold fell by 4.9%. Generally, the strength of commodity prices has been a feature this year and, perhaps, a precursor of rising inflation.

ECONOMICS

The economic news, on the face of it, could not be much better. Respected economic forecasters, such as the IMF and the OECD, have been busy revising upwards their forecasts for global economic growth and trusted forward-looking economic indicators, such as Purchasing Managers' Indices, suggest that supply side confidence is growing healthily in most parts of the globe. In the real world, western consumers are more confident that normality is around the corner and the outlook is changing as the response to COVID looks, increasingly, as if its effectiveness will endure. Aside from the gargantuan amounts of government stimulus, it has always been hoped that economic activity will be spurred by a great deal of spending that has been deferred over the past twelve months rather than lost completely and the consensus is that this remains the case but, in the context of this review, there is a need to interpret the macroeconomic background and understand what it means for capital markets. Equity markets hover at, or near, all time highs and rises have been surprisingly consistent with volatility only emerging in short bursts. Now, just as at any time before, there is good reason to caveat this economic spring flourish with some of the various risks which present at this time.

As we pass the anniversary of the worst part of the crisis, the dust is still settling and it looks like the damage done by COVID in 2020 will be reflected in a 3½% shrinkage of the world economy. Just as the human cost of this pandemic has been cruel and uneven, the economic damage has been, too. This is particularly the case given the abruptness of the crisis where the IMF estimates quarter on quarter, the world economy shrank by 17.2% annualised in the first quarter of 2020. Recovery over the three following quarters reduces the contraction to 3½% figure. This shrinkage is the sum of lost jobs, furloughed staff and closed businesses and advancing the calendar by a year, we are now finding out whether what happened a year ago was a temporary superficial wound or if there is permanent scarring left behind. At a global level, expectations of a strong recovery are greater now than they have been with the OECD estimating that the world economy will now grow by 5.6% in 2021, which also represents a 1 percentage point revision from its estimate only four months earlier and the figure for 2022 is now 4%. Perhaps more useful than dry statistics is the estimate that global output will rise above pre-pandemic levels by mid-2021. Referring back to the unevenness of the damage done, many countries will remain below their pre-crisis output levels for 18 months after that first date. Thinking of what makes the difference between a fast recovery and a slow one, a country would benefit from a high vaccination rate and effective public health policies, strong monetary and fiscal support from government and its central bank and a socially cohesive population that could work from home. One measure of employment used by the OECD is lower and higher [people] contact sectors. An economy built on lower contact sectors has been more resilient than one dependent on higher contact sectors, such as hospitality and tourism. With this in mind it is easy to see how uneven the recovery will be.

Looking at economic downturns from an academic perspective all share similar characteristics as just being part of the economic cycle and it is worth reflecting on that to consider what may happen next. Firstly, an economic crisis sees a drop in consumer confidence; the trigger in 2008 was very different from the trigger in 2020. This leads to a fall in consumer spending and investment, job losses, a contraction in the size of the economy and a reduction in tax revenue to the government. Falling inflation and interest rates normally accompany the decline in activity. This may be followed by a period of stagnation before expansion returns. The most human part of this is, of course, the element of consumer confidence which in good times is precious and at all times can be quite ephemeral. The question which is perhaps being answered right now is how resilient consumer confidence is proving to be. At best, consumers have unwillingly deferred spending but at worst that missed consumption has been lost and future consumption will be reduced relative to what it would have been without COVID.

Individuals have swapped consumption for saving, and the Bank of England has put a figure on this, something it has called accidental savings, and its estimate is that between May and November 2020 British households grew their savings by an extra £125 billion. This is five times more than in any other six month period in history. Research suggests that over half of that has been retained in current accounts implying that it is the more favourable outcome of deferred spending that will result. The Bank also observes that the spike in savings is particularly high in those aged between 35 and 44. Current forecasting favours the view that money saved on commuting, holidays, restaurants and cinemas over the last twelve months is likely to be spent to fund a form of what might be called catch-up lifestyle.

Just as consumers have swapped consumption for saving until now, countries have the option of increasing debt for recovery. The arguments against doing this seem largely absent and all governments and most opposition parties are endorsing the view that the cost of not doing this is far higher than the cost of doing this. Whilst this seems to have been adopted universally as a policy it goes without saying that the long term effect on any country’s finances will vary depending on many factors, but the country’s starting level of debt and the level of control it has over its currency would seemingly be two of the most important aspects of debt management.

The bond market is always an asset class to consider - both in itself and at this time for the potential spill over effect into other asset classes should it become distressed, though bonds form a market that Meridian has avoided for some time, apart from where specific mandates require them. Ever lower interest rates and artificial demand has driven up bond prices to stratospheric levels and, given they will mature at some point at par, they either promise ultra-low or negative real returns until that point whilst interest rates are low, or, in the case of rising interest rates, guaranteed losses as capital values fall to accommodate higher yields. Good luck to those buying bonds today in the expectation that interest rates will fall even further, pushing the bond bull market further on. Looking at government debt markets, and the UK as a representative example, the government has spent more than in previous years and swung deep into deficit as support for the economy has been accompanied with lower tax take. 3.6 million new claims for universal credit, a peak of 8.9 million workers furloughed and 2.6 million self-employed receiving income grants collectively paint an economic picture of COVID. In the last fiscal year (2020/21) the budget deficit reached 16.9% of GDP and is forecast to fall to 10.3% of GDP in this fiscal year, which will still be higher than during the Great Financial Crisis of 2009/10. The stock of debt has reached the highest level, as a share of the economy, since the late fifties though the cost of servicing is at an historic low due to the low interest rate environment. Whilst the Bank of England owns roughly a third of the £2 trillion of national debt, just over another third is owned by banks and insurance companies who do not hold them as profitable investments but as capital items or for liability matching purposes. This simplistic model leaves another layer of the market which must consider the total return on its investment and it is patently untrue to say that Gilt yields are immune to changes in market conditions.

In the first quarter of 2021 we saw 10 year UK Gilt yields rise from 0.19% to 0.84% as inflation expectations grew. As an example, the ¼% 2031 Gilt experienced a price drop of 6.6% as a consequence of this relatively small move in yields and further rises in expectations of future inflation and interest rate increases will lead to further incremental price drops. These paragraphs on bond markets directly follow observations about enduring consumer confidence and catch-up lifestyle consumption and further back in this piece the slightly flippant comment about the good economic news. Inflation will grow as a function of a changing balance of supply and demand in all markets and that may be the purchase of a more expensive than usual airline ticket, 40p on a pint or stimulus spending from government on a major new infrastructure project. Bond yields will rise with inflation and, as they do, we will reach a point where an attractive real gross redemption yield on bonds presents but we are some time away from that point.

Whilst it's easy to think of bonds and equities as competing asset classes and, indeed, classic portfolio construction has included a balance of bonds and equities because, historically, if one falls the other tends to rise, inflation and, ergo, higher interest rates present a risk to both markets. Over a number of years the distended bond market has made the dividends on equities look comparatively attractive but the advantage of dividend yields over 10 year bond yields is reducing and is likely to reverse at some point. Despite rises, yields are still near all time lows but it is important to consider what spillover effects rising bond yields could have on equity markets. The best scenario, and one that is realistic at the moment, is that rising yields would be accompanied by an improving economy and supportive central banks that continue to provide well signalled policy responses. It would also be reasonable to expect an improving economy to lead to earnings revisions which would be positively and broadly reflected in equity prices. It would also be reasonable to see this as a period of higher inflation and current market indicators are already pricing this in. The Federal Reserve has already revised its inflation targeting policy from at or near 2% to an average of 2% over a period of time which reflects both an expectation of higher inflation and a tolerance of it; a positive of high inflation is that it naturally erodes the real value of debt which at a time of high debt would not be a bad thing for borrowers and those who had mortgages in the early 1980s will remember this effect. Looking back to May 2013 we find a good example of a bad outcome. In what is now called the Taper Tantrum, the Federal Reserve surprised market participants by announcing its future intention to slow down its bond buying programme which caused a spike in yields and equity market volatility increased and indices fell. Over a one month period the FTSE World Index (in sterling terms) fell 9.8% but markets move for a multitude of overlapping and contrasting reasons and by the end of the year the damage done from the interpretation of these few words had largely been forgotten, if measuredly solely by the growth in equity markets as 2013 was a year that saw an above-average double digit rise.

Looking further back to the start of the Great Financial Crisis the sentiment in some central banks was, initially, that the bailing out of a bank in trouble - Northern Rock springs to mind, should be considered in view of the issue of moral hazard. What message would a bail out send to other banks? It could appear that the downside risk to overly aggressive banking practices was limited by the security of the central bank's actions. More than anything the rapid scale of escalation through 2008 and into 2009 meant that central banks adapted their views to do everything within their powers to avert the worst outcome, as the worst outcome was, potentially, a total collapse of the banking system. Moving forward a decade we now see that central banks and governments have been consistently on the front foot and worked diligently to be seen to support financial markets, banking systems and the wider economy.

Now a year into the COVID crisis we haven't had a banking sector crisis because banks were stronger at the start of it, due to Basel III, the capital rules developed in response to deficiencies of 2009 and governments have supported bank lending to business. Credit conditions have been maintained and companies can continue to operate, as best they can, knowing that support will be ongoing. Using the United Kingdom as an example, the new Recovery Loan Scheme was announced on 6th April 2021 offering a government guarantee on 80% of an approved loan and an interest rate cap and following on from previous schemes which backed £75 billion of loans over the previous twelve months. The wider support package amounts to an unprecedented £350 billion and at its peak there were 3.6 million new claims for universal credit met, 9.8 million people furloughed and 2.6 million self-employed people receiving an income grant. The level of government support over this most recent economic crisis far exceeds anything that was done in 2009.

Bond markets have been greatly affected by quantitative easing as the artificial demand from central banks has, by design, reduced yields. This flattening of the yield curve has had a number of effects but in the first order it has supported business and created economic growth by making lending cheaper and increasing liquidity, the second order consequences are inflated house prices and the price of other real assets, a rise in corporate debt levels and a less profitable banking sector. Referring back to the rose-tinted first paragraph of this review, this is where the risk lies. We may now see a combination of various factors all driving inflation higher with the risks that come with that. Government stimulus and central bank largesse may prove to be counter-cyclical as consumers play lifestyle catch-up and spend their way out of COVID. With world growth forecast to be 5½% in 2021 and 4% in 2022, cost pressures are bound to appear and we are already seeing forward-looking commodity prices spiking. Copper has touched $10,000 per tonne, where it was $4,300 a year ago and iron ore has doubled to $180 per tonne over the same twelve months.

Direct government financial support has been abundant in almost every country around the globe and the balance sheet expansion of central banks has been equally eye-catching. The Federal Reserve's balance sheet has doubled to around $7.8 trillion over the last 18 months and, for reference, in 2008 it was almost a tenth of the size it is now, at $860 billion. This stimulus has, despite being an economic experiment, had the effect that was hoped for but the exit plan is not clear at the moment. A central banker must express ongoing support for the economy, avoid any sharp movements and plan for the arrival of inflation and, eventually, though a long time off it would currently seem, the reversal of QE. The unknown here is what level of inflation we will see and what the policy response will be in quelling any uncomfortably high inflation. A key aspect of any decision making will be an assessment whether inflation is transitory or persistent but what is pretty sure is that throughout history countries that run persistently large deficits have seen rises in inflation. We have seen rises in bond yields in 2021 which translate into capital falls and much points to the possibility of the recent trend continuing.

If, as now seems likely, we are entering a period of higher inflation, it is important to consider what the consequences might be for markets. Controlled inflation is not unhealthy in most circumstances as it is usually associated with positive economic growth, which should translate into rising corporate profits, which will, in turn, translate into stronger equity markets. If inflation were to reach, say, 4% to 5% in the United Kingdom, and looked like it was becoming a persistent feature, then policy makers would feel obliged to act and the starting point could easily be tighter monetary policy. By raising interest rates and tightening the money supply, possibly by reversing quantitative easing, a deflationary effect would be expected. This could be disruptive and cause a reassessment of the general pricing of equities, creating volatility and falls in values. The stocks least affected by higher inflation would be those which can raise their prices in line with inflation and which are supported by real assets. Two examples of sectors that might do relatively well in such market conditions would be energy stocks and property companies such as Real Estate Investment Trusts. The price of oil is likely to rise in step with inflation and property companies which own bricks and mortar would expect rises in the value of those properties and are likely to have lease contracts which are inflation-linked. Some more speculative growth stocks may see their share prices fall, relatively or absolutely, particularly those which are forecasting high levels of future growth and profits but currently do not make any money. Those future income streams are less valuable today in times of higher inflation and, ceteris paribus, reflected in a lower share price. In support of this thinking we have seen volatility in the NASDAQ index of technology stocks so far this year and at the time of writing it is up 4.0% in sterling terms compared with the broader S&P 500 which is up 10.0% in sterling terms. Should the effects of higher inflation lead to economic instability and a fall in aggregate demand then these observations may become less convincing as cyclical stock such as oil companies suffer and REITs see their occupancy rates fall.

It has been a number of years since bonds were routinely included in Meridian portfolios and as interest rates have fallen to levels that would have been barely believable 20 years ago, bond markets have risen strongly. In our view that growth has carried bond prices to a point that will, more likely than not, lead to further losses in the coming years; we have had a foretaste of such falls this year. Even though gross redemption yields are now higher than three months ago, the yields in real terms (adjusting for now higher inflation) are just as unattractive. There is also a likelihood of higher volatility in equity markets if inflation starts to spike and at times like this it is important to have a diversified portfolio of equities, where mandates permit. This would cover both growth and value stocks and consist of strong, diverse companies that lead in their field and have shown themselves to have resilient earnings growth over a long period.