meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Equities have enjoyed a positive quarter with most markets moving higher and, in the case of Japan, spectacularly so. Bonds have also performed well, whilst commodities have weakened, perhaps giving a glimpse of light to the world economy. In the currency markets, the yen, as a result of a spectacular change in the direction of Japanese monetary policy, has weakened, resulting in the rally in Japanese equities noted above.

The tables below detail relevant movements in markets:

International Equities 31.01.13 - 30.04.13

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+8.4	+9.9	+7.8	+11.0
Finland	+6.6	+5.5	+3.6	+6.6
France	+4.3	+3.2	+1.3	+4.3
Germany	+1.9	+0.8	-1.1	+1.9
Hong Kong, China	-0.6	+1.2	-0.7	+2.3
Italy	-3.9	-4.9	-6.7	-3.9
Japan	+24.8	+19.1	+16.9	+20.4
Netherlands	-0.4	-1.4	-3.2	-0.4
Spain	+1.0	-0.1	-1.9	+1.0
Switzerland	+9.8	+9.6	+7.6	+10.8
UK	+3.8	+3.8	+1.9	+4.9
USA	+7.2	+9.2	+7.2	+10.4
Europe ex UK	+4.0	+3.2	+1.3	+4.3
Asia Pacific ex Japan	+3.7	+5.4	+3.5	+6.6
Asia Pacific	+12.5	+11.3	+9.3	+12.5
Latin America	-3.5	-1.2	-3.0	-0.1
All World All Emerging	-2.3	-0.5	-2.3	+0.6
The World	+6.6	+7.3	+5.4	+8.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +3.8%

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

Currency	31.01.13	30.04.13
Sterling	2.14	1.65
US Dollar	2.01	1.64
Yen	0.78	0.60
Germany (Euro)	1.71	1.19

Sterling's performance during the quarter ending 30.04.13 (%)

Currency	Quarter Ending 30.04.13
US Dollar	-2.1
Canadian Dollar	-1.1
Yen	+4.5
Euro	+1.1
Swiss Franc	+0.3
Australian dollar	-1.5

Other currency movements during the quarter ending 30.04.13 (%)

Currency	Quarter Ending 30.04.13
US Dollar/Canadian Dollar	+1.0
US Dollar/Yen	+6.8
US Dollar/Euro	+3.2
Swiss Franc/Euro	+0.8
Euro/Yen	+3.4

Significant Commodities (US dollar terms) 31.01.13 - 30.04.13 (%)

Currency	Quarter Ending 30.04.13
Oil	-11.4
Gold	-12.0

Markets

International equities have continued their upward trend over the last quarter, with the total return on the FTSE World Index, in local currency terms, being 6.6%, in sterling terms 7.3%, in US dollar terms 5.4% and in euro terms 8.5%. Looking at local currency returns first, the stand out feature was Japan where the election of a new Prime Minister, Mr Abe, with new policies, galvanised the market. At the other end of the spectrum, Latin America and emerging markets continued to lag, with respective negative returns in the FTSE Latin American Index of 3.5% and the FTSE All World All Emerging Markets Index of 2.3%. Elsewhere, Australia turned in a strong performance, with the FTSE Australia Index returning 8.4%. Apart from the yen, against which sterling rose by 4.5%, currency movements were subdued during the quarter. Sterling weakened slightly against the North American currencies but strengthened against the euro and Swiss Franc. With currencies not affecting sterling performances too significantly, the Japanese market, notwithstanding that the yen was the weakest currency, still produced a stellar performance, returning 19.1% in sterling terms. Above average performances were seen from the FTSE Australia Index, up 9.9%, and from the FTSE USA Index, up 9.2%.

The high quality bond market continued to attract support, notwithstanding the very low yields upon which these sovereign books sell. Taking ten year government bonds as a benchmark, the gross redemption yield on UK government bonds fell by 49 basis points to 1.65%, that of US Treasuries by 35 basis points to 1.64%, that of Japanese Government bonds by 18 basis points to 0.6% and that of German Bunds by an astonishing 52 basis points to 1.18%.

As we said, there were not huge movements in the currency markets. Against the yen, sterling rose by 4.5%, as indicated above, and it was slightly higher against the euro, 1.1%, and the Swiss Franc, 0.1%, but against the US dollar it fell by 2.1%, the Canadian dollar by 1.1% and the Australian dollar by 1.5%.

Significantly, and we will come back to this, commodities were weak. Oil, as measured by Brent crude fell by 11.4% and gold by 12.0%.

Economics

The story remains the same, as it has for a while, with stock markets performing well and the world economy patchily, with western Europe stuck in the mire and exhibiting its economic decline almost on a daily basis, the USA showing modest growth, Japan in the doldrums and China, with an annualised growth rate of 7.7% in the first quarter, disappointing many analysts but still showing a rate of growth of which the UK and eurozone, let alone the USA and Japan, can only dream. It is, therefore, a curate's egg, good in parts and bad in others, but the important conclusion is that it is not wholly bad.

The latest IMF World Economic Outlook projections, just published, project a slightly lower growth rate than the one given in January. The IMF now forecasts that world output will grow by 3.3% this year, a 0.2% reduction on January's forecast, whilst next year's projection remains unchanged at 4.0%. Unsurprisingly, advanced economies are expected to have a bad time, increasing output by just 1.2%. Within that, the USA is expected to lead the way amongst the biggest economies with growth of 1.9% but, unsurprisingly, the euro area is expected to be a drag on growth, contracting by 0.3%. The number 2, 3 and 4 economies in the eurozone, France, Italy and Spain, are all expected to contract this year by 0.1%, 1.5% and 1.6% respectively. Japan, the UK and Canada are expected to grow by 1.6%, 0.7% and 1.5% respectively. Other advanced economies, which exclude the G7 countries and eurozone countries, are expected, as a bloc, to grow fastest of all at 2.5%. When we move to Emerging Market and Developing economies, the forecast, as we would expect, increases to 5.3% growth for this year. Notwithstanding the slightly disappointing first quarter growth rate from China, the IMF still has a forecast of 8.0% for this year and for India of 5.7%. After a very disappointing 2012 economically when the Brazilian economy grew by just 0.9%, the IMF forecasts growth of 3.0% for this year. An increasingly bright star is Mexico, where the new President is enacting promising reforms. Growth here is expected to be 3.4%, down on last year's 3.9% but, nevertheless, higher than this year's forecast for Brazil. Sub Sahara Africa is forecast to grow by 5.6% against 4.8% last year. Inflation is forecast by the IMF to remain low at 1.7% in advanced economies (2.0% last year) and unchanged in Emerging Market and Developing economies at 5.9%. As implied by the slightly higher growth forecast for 2014 for the world economy (4.0%), most areas are expected to put on a better performance. But these are early days and we must not forget that the growth forecast for this year is lower than most forecasters had expected.

The economic stories which have dominated the news for so long continue to do so and it is a reasonable assumption that the situation will remain unchanged for as far ahead as we can see. The eurozone is probably still the largest issue as its problems become worse. Evidence of internal tensions between the dominant member, Germany, and the debtor nations, as well as some of the bigger countries, like France and the Netherlands, grows as there are signs that countries are willing to call Germany's bluff. Requests for extensions to bail out loans, France abandoning its 3% budget deficit target for this year and Italy challenging the austerity programme following the election of an anti austerity majority and Spain seeking longer to achieve its budget deficit targets, are all straws in the wind that tectonic plates are moving within the eurozone. Angela Merkel, the most powerful person in the eurozone hierarchy, is the ultimate politician totally focused on her re-election prospects. The eurozone crisis is providing something of a headache for her. At home, her FDP allies are struggling to achieve the 5% threshold that they need for parliamentary representation and a new anti euro party has emerged which threatens to take away CDU votes. This is not a party on the populist fringes but a serious party founded by academics. From the Left, Oskar Lafontaine, one of the architects of the euro, has now called for it to be broken up. He was the German Finance Minister when the euro came into existence in 1999. Linked with this is the strong theme that the German electorate is suffering from bail out fatigue and resent the extent of the liabilities which Germany is taking on. The bailout countries are in a desperate situation with austerity being forced upon them and also levels of unemployment which most people would consider completely unacceptable, particularly amongst the young who are often victims of employment laws which favour those in work at the expense of those out of work. Whilst the euro is not the only reason for the eurozone's problems, it bears a major part of the blame since these uncompetitive countries are locked into a monetary union which denies them the possibility of devaluation and temporary respite from, for them, an uncompetitive exchange rate. So committed are eurozone lenders to the euro project that they cannot bring themselves to admit that it is failing and so even more deprivations are visited upon these troubled countries. But one gets a feeling that rebellion is in the air. There is only so much pain that any country and its citizens can take before the electoral representatives are replaced and, of the big non bailed out countries, Italy may be an example. Although he has only just been elected, President Hollande has become deeply unpopular, having campaigned on an anti austerity ticket and, now, France has abandoned its target of a 3% budget deficit this year. It must be remembered that in the early days of the euro, France and Germany both ignored the disciplines of the Stability & Growth Pact because it did not suit them and this set an unfortunate example for others with consequences which we now see.

So, if we are correct in saying that the troika's austerity instructions are being challenged and ignored in certain countries, what are the consequences? After all, current eurozone bond yields of countries which may be in trouble are far less stressed than they were and are still benefiting from Mr. Draghi's statement last summer that the ECB will do whatever it takes to save the euro (we paraphrase). The ECB's unlimited bond buying in those circumstances was predicated on countries asking for a bail out and therefore having their economies effectively run by the troika. So far, no country has requested a bail out since Mr Draghi's speech (apart from Cyprus) and Spain and Italy were the favourites at the time. But both countries have been emboldened in their different ways. Italy has had an election which rejected further austerity and, in a way, the weaker you are, the stronger you are. If Italy, the third largest eurozone economy, were to leave the euro, the project would be dead so the country has more bargaining power than one might expect. In fact, Italy is running a primary budget surplus which puts it in quite a strong position, a primary budget surplus being one where, excluding interest payments, the budget is in surplus. Italy's problem is a very high level of outstanding public debt in relation to DGP and a very poor growth record as a result of major structural rigidities in the economy. For Spain, with unemployment at 27% and youth unemployment at 56%, austerity is making a desperate situation even worse and the signs are that the government has reached the limits of its tolerance of the austerity programme being thrust upon it by the troika. One would think Spain will start to question the wisdom of being in a fixed currency regime which the powers that be seem determined to maintain, whatever its cost, and it is proving to be enormous.

Economists talk about automatic stabilisers. When an economy is in trouble and unemployment rises, a cause of increased government spending, and tax revenues are already adversely affected, public finances deteriorate. If nothing is done to correct this situation, the increased level of government spending helps to stabilise the economy. But, if the government in question tries to tackle the worsening public finances with tax increases and spending cuts, this is pro cyclical and worsens the state of the economy in question. This is what the austerity programme being forced upon some eurozone countries is doing and it creates a vicious spiral of economic decline. If countries like Italy, which has just cancelled tax rises of up to €6 billion this year, start to allow the automatic stabilisers to function, it may help the economy in question. In so far as the working of the automatic stabilisers, if allowed to operate, may help the eurozone economy, this could be helpful to the stock market. However, the deficits of the affected economies, together with maturing debt, still have to be financed, and the ECB, not to mention Germany and its Constitutional Court, may not be happy to do this. Anything which suggests monetising of the debt would be illegal. Compare this with the relatively favourable position of the UK in this respect. The UK government, for various reasons, including the problems of the eurozone, has fallen well behind its original deficit reduction targets and the latest figures for 2012/3 show borrowing only fractionally below that of the previous year. One of the reasons for this is that the government is allowing the automatic stabilisers to work rather than piling on additional pro cyclical reasons to try to drive down the deficits and risk a decline in economic activity over and above what has already occurred. Not being in the eurozone and being able to operate an independent monetary policy is beyond price at the present time.

So, the loosening of the shackles by the troika on some countries may help the GDP numbers but still cause issues about the funding of the deficits. The fall in eurozone government bond yields, even amongst the troubled periphery, is not due to any improvement in the outlook and there is a disconnect with economic reality which could blow up at any time. Furthermore, any relaxation must not lead to a lessening of the pace of structural reform. These eurozone countries need to grow out of their difficulties. Economic growth and strict control of public expenditure are the best way to tackle deficits for they should improve tax receipts and restrain public spending, which rises during a recession. Unfortunately, in the past, governments have used the good times to increase public spending when they should be allowing the automatic stabilisers to work the other way, i.e. use increased tax revenues and lower public spending to improve public finances. Whilst some structural reforms are being enacted at the behest of the troika, much more is needed to be done in the labour and product markets to increase the potential rate of economic growth in many eurozone economies. Investors, particularly in the eurozone bond markets should not be fooled by the apparent benign conditions. The economic situation, as the latest IMF forecasts show, is very poor in the eurozone and getting worse, even in Germany, the powerhouse economy. We now have the latest EC forecasts for the eurozone, just published, which project a decline of 0.4% in the eurozone economy this year. Of the biggest countries only Germany, +0.4%, is forecast to grow whilst France (-0.1%), Italy (-1.3%), Spain (-1.5%) and the Netherlands (-0.8%) are forecast to contract.

Before completing our discussion on the eurozone, we can review in no particular order items of news from individual countries over the past month. In the Netherlands, the consensus over austerity is breaking down. €4.3 billion in cuts in 2014 is due to make the budget keep within deficit limits which have been laid down. In France, a potential problem for the eurozone given its size, it has received a rebuke from the EU about the pace of reforms. France has delayed targets for reducing its deficit to 3% of GDP as it was supposed to do this year. It now forecasts a deficit of 3.7% of GDP this year based on a reduced growth forecast of 0.1% for this year. Its target for 2014 is predicated on growth of 1.2% in that year which could prove optimistic. Unemployment in France rose for the twenty third month to 3.2 million, higher than the 1997 peak. In Spain, the central bank estimated that the Spanish economy contracted by 0.5% in the first quarter. In the first quarter, the Spanish unemployment rate rose by 1% to almost 27.2%. In saying that two extra years are needed to get its budget deficit back below 3%, the authorities forecast that the Spanish economy will contract by 1.3% this year, whilst forecasting growth of 0.5% next year. The Finance Minister forecast a budget deficit of 6.3% against an initial target of 4.5%. Whilst the EU has given Portugal and Ireland up to seven years to repay their bail out loans, Portugal's Constitutional Court delivered an unwelcome blow to the government's austerity programme by striking down some items of the programme relating to the public sector pay savings. If alternative measures were not taken to offset the loss of these measures, the budget deficit would increase by 0.8% of GDP to about 6.4% of GDP.

Dealing with the eurozone in general, it was interesting to note that the eurozone's woes have, not surprisingly, led to a loss of confidence in the euro amongst some countries. According to the IMF, developing countries sold €45 billion out of their foreign exchange reserves in 2012, reducing the proportion of euros in countries' foreign exchange reserves to 29% from a peak of 31% in 2009. The importance and influence of the forthcoming German election can be seen in Germany's reluctance to progress a European Banking Union with its insistence on a revision of EU treaties. A dismal Markit PMI for eurozone manufacturing in April at 46.5 adds to the gloom, whilst the composite index for the powerhouse German economy showed a reading of 48.8, a six month low.

A month ago, we would have been talking much more about Cyprus. How quickly it seems to have moved away from the headlines but the implications of how the country was treated live on, especially in relation to uninsured depositors. A line was crossed and although the storm has died down, what was done to depositors of the two Cypriot banks could cause a run on eurozone banks in troubled countries in future. With capital controls in place, a Cypriot euro is not the same as other euros because it is not, as yet, freely transferable as it should be in a monetary union without capital controls.

Our view has not changed on the eurozone. Its inherent contradictions will overwhelm it and electorates in the troubled countries will not stand for the measures that they are being asked to swallow to shore up an unsustainable currency union. Sooner or later, a government or governments will be elected which will reject the euro and everything unpleasant which it brings with it for the economies in question. However, as we have said many times before, we must distinguish between a sovereign in the eurozone and companies domiciled in the eurozone. The latter can still be attractive investments. They have to be well run to survive, they often have an attractive geographical spread of interests and they are well used to handling currency situations. It would be a mistake, we believe, to omit eurozone based stocks from a portfolio.

Some may say that this analysis on the eurozone is too simplistic. It is so established and touching every area of the economies in the eurozone that it would be impossible to unravel. Yes, it would be extremely messy and cause huge problems, particularly in the banking sector, but, in the medium and long term, continuing with a monetary union which is based on such fragile foundations is even worse. Already a whole generation is blighted in Greece and Spain by unemployment, all in the name of trying to hold together the impossible. Whilst we feel positive about the prospect for some eurozone equities, it is impossible to feel the same about eurozone bonds where there is a currency (if the euro breaks up) risk and a credit risk.

In the USA, the absence of agreement on a budget has led to the sequester coming into force, lopping off spending from defence and discretionary federal expenditure and reinforcing the effect of the tax increases, including the full restoration of the payroll tax cuts. So the economy is facing headwinds which does not alter the fact that the USA, like many other countries, has to put its fiscal house in order given the projection of government spending over future years, including a ballooning entitlement programme. Nevertheless, although below forecast, the first estimate of first quarter GDP growth was annualised a 2.5%. Depressing the figure was, not surprisingly, defence expenditure because of the sequester. On the positive side was consumption which added 2.2% to the total. Business investment was up 0.5% and housing contributed 0.3%. Inventory building accounted for another 1%. The Purchasing Managers Index for April for the manufacturing sector was slightly disappointing, remaining just in positive territory at 50.7 against 51.3 in March. That for the services sector, at the end of April, although lower than at the end of March, was still reasonably well into positive territory at 53.1 against 54.4. The April non farm payroll figure at 165,000 new jobs was above expectations and below the previous month's upwardly revised 138,000, although monthly figures are volatile and are of limited significance. The corporate earnings season has been mixed so far for the second quarter with the stronger dollar affecting some companies and some showdown in emerging markets, whilst Europe remains difficult for many companies. But, overall, there is no cause for concern and dividend increases and share buy backs remain well in evidence. Those who are bearish about US equities, as well as for other markets' equities, cite high profit margins and the share of profits in GDP as being unsustainable and suggest that, if they revert to mean, shares will look expensive. We do not agree with this view given that we believe profits will hold up reasonably well.

Turning now to China, there was some disappointment with the first quarter's annualised growth figure of 7.7%. The Chinese government is trying to rebalance the economy away from fixed investment, property and exports and more towards consumption. Rapid wage rises have eroded China's competitiveness with other Asian economies, putting the pressure on low value added work as China moves towards higher value added production. Inflation always remains a concern for the Chinese authorities as it could fuel social unrest. China has been allowing the currency to appreciate, which helps to keep down import prices and also takes the pressure off other countries accusing it of manipulating the exchange rate. In fact, prices fell by 0.9% in March to give a year on year rate of increase in the Consumer Price Index of 2.1%. The latest Purchasing Managers Index for the manufacturing sector for April stood at 50.6 against 50.9 the previous month, whilst that for non manufacturing on the previous month basis stood at 55.6 against 54.5. With business conditions so poor in western Europe, the world economy needs strong growth from China, India, other relatively fast growing Asian economies and emerging markets. That is why China is so important and it will be watched closely by investors. But its growth rate is one of which many advanced economies can only dream and its influence on the world economy remains positive.

The biggest new event in the world economic scene has occurred in Japan when Mr Abe and his new government, together with the Bank of Japan, have embarked on a very radical strategy to try to get the Japanese economy moving and this from a position where gross Japanese public debt as a percentage of GDP is an eye watering 230%. Their policy is extreme and risks the debasement of the currency, a strange thing to say about the yen which one usually associates with strength. The Bank of Japan intends to double the country's monetary base from JPY135 trillion (US$1.43 trillion) to JPY270 trillion by March 2015. The Bank of Japan intends to extend the maturity of the bonds it buys to control interest rates beyond three years but that does pose a risk to the Bank of Japan should interest rates rise. The intention is to raise the average maturity of the government bonds which it holds from three years to seven years. The target inflation rate is 2% with the aim of eliminating the deflationary trends in the Japanese economy which, besides raising the real value of outstanding debt, discourage spending by businesses and individuals who expect prices to fall. The latest year on year inflation rate for Japan is -0.6%. All of this action has had the desired effect of weakening the yen, as our table at the beginning of this review shows, and the effect on the Japanese stock market has been electric. The cheaper yen makes Japanese goods much more competitive and can have an immediate effect on companies' profitability. Japan has to be careful, however. Whilst Japan has vast overseas assets, its current account position has deteriorated significantly as a result of its trade account (part of the current account) moving into deficit as a result of the need for increased energy imports following the nuclear disaster in the aftermath of the tsunami and earthquake. The latest current account data shows a surplus after three months in deficit. The point is that a weaker current account position could exacerbate yen weakness to a position well below what the authorities would desire. At the moment, the change in monetary policy has excited investors, with the fall in the yen not detracting from still excellent recent currency adjusted returns from Japanese shares. An example of the change in sentiment is that the fall in the value of the yen is shown by one of the sub sections of the recent Tankan survey. Although the headline figures showed very little change, the reading for large car makers improved dramatically. If this feeds through to the economy, it could help to raise growth prospects.

For the UK, the big news was the fact that the UK seems to have avoided a triple dip recession, with first quarter growth at 0.3% over the previous quarter. In truth, these are rounding errors, but the symbolic significance is important, given that the Chancellor is under pressure to relax his deficit reduction programme. In our opinion, to do so would be highly irresponsible. The UK has one of the worst budget deficits amongst the main industrialised countries, lagging only Japan and, with Fitch joining Moody's in downgrading the UK's credit rating, we think that the UK would be playing with fire by spending more. As we mentioned earlier, the Chancellor is allowing the automatic stabilisers to work, as evidenced by the fact that last year's government borrowing level was only fractionally below the previous year's level. As it happens, critics of the government were given some ammunition in the form of the IMF's latest report on the UK which shifted its ground, perhaps because of internal debates within the IMF, in favour of implementing a Plan B. We do not believe that the markets would react well to a U-turn by the Chancellor. One idea from those who want to boost the economy is to cut VAT, rather as the last government did temporarily. It was not a successful experiment and the fact that the UK has a high marginal propensity to import means that much of the increase in demand (if it occurred) would benefit foreign manufacturers. The UK is in a very difficult position with such a serious imbalance between spending and revenue. It retains the priceless advantage of maintaining its own currency and monetary policy, but that does not mean that it can take irresponsible risks. It is going to be a very long haul back to normality. However, we must, as always, distinguish between companies domiciled in a troubled country and the fortunes of the country itself, in this case the UK. The UK retains many world class companies from which investors can choose.

There is one shaft of light for many countries in the form of lower commodity prices. There has been a general fall in price levels which should increase the value of take home incomes and, for businesses, lower costs help profitability. These lower commodity prices could just give the world economy the boost it needs.

In summary, our view remains unchanged. Bond yields have been driven down to levels which offer no value and risk substantial losses. Many investors have no option other than to invest a certain amount in bonds which, together with ultra low short term interest rates and quantitative easing, has driven down yields. At some stage, quantitative easing will have to be reversed, with the almost certain rise in interest rates which this will cause. Negative real yields are unusual and bonds represent a very unattractive investment option. In search of yield, investors have moved sown the credit rating chain, driving down yields in low quality bonds. We believe good quality equities offering attractive yields pose much less risk. Although equities have risen quite strongly, in our view of the world economy, which certainly cannot be called bullish, they still offer decent value although, obviously, not as cheap as they were. Because of the troubled economic and political background (North Korea, Iran, the Japanese/Chinese stand off over the disputed islands, the Middle East etc), we think there are bound to be periods of setback which will give investors, with cash building up, the opportunity to top up their equity holdings. We live in extraordinary economic times, with markets seriously distorted by the extreme monetary policy being followed by many countries. This is not in the interests of the world economy and it is essential, even though it will provide challenges to the market, for the situation to be normalised, though, realistically, this seems some way off.

So, we maintain our view that, in this extraordinary environment, equities remain the asset of choice, although with expected volatility around an upward trend which should give an opportunity to top up holdings. Bonds remain dangerously over priced.