meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Despite some weakness in international equity markets in February, shares largely held on to gains made in previous quarters. Volatility, which has been low for a long time, suddenly increased sharply, leading to a significant casualty in the short volatility market, which, temporarily at least, spooked investors. Bond yields rose on fears of higher inflation and a more aggressive monetary tightening by the Federal Reserve in the U.S.A. Currency movements were less pronounced than in some previous quarters although U.S. dollar weakness persisted. In the commodities markets oil and gold rose slightly in U.S. dollar terms.

The tables below detail relevant movements in markets :

International Equities 30.11.17 - 28.02.18

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.6	+2.5	+4.3	+2.0
Finland	+6.7	+7.2	+9.1	+6.7
France	-0.6	-0.1	+1.7	-0.6
Germany	-3.6	-3.2	-1.4	-3.6
Hong Kong, China	+4.8	+2.8	+4.6	+2.3
Italy	+1.5	+1.7	+3.8	+1.5
Japan	-1.2	+1.8	+3.7	+1.3
Netherlands	-0.7	-0.2	+1.6	-0.7
Spain	-2.9	-2.4	-0.7	-2.9
Switzerland	-4.6	-2.6	-0.9	-3.1
UK	-0.7	-0.7	+1.1	-1.2
USA	+3.1	+1.3	+3.1	+0.8
All World Europe ex UK	-1.2	-0.5	+1.2	-1.0
All World Asia Pacific ex Japan	+4.0	+3.2	+5.0	+2.7
All World Asia Pacific	+1.9	+2.6	+4.5	-2.1
All World Latin America	+12.4	+11.5	+13.5	+11.0
All World All Emerging Markets	+6.6	+6.7	+8.6	+6.1
All World	+1.8	+1.2	+3.0	+0.7

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : -0.4%

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

Currency	30.11.17	28.02.18
Sterling	1.39	1.59
US Dollar	2.39	2.93
Yen	0.04	0.04
Germany (Euro)	0.38	0.62

Sterling's performance during the quarter ending 28.02.18 (%)

Currency	Quarter Ending 28.02.18
US Dollar	+2.0
Canadian Dollar	+1.3
Yen	-3.1
Euro	-0.6
Swiss Franc	-2.1
Australian Dollar	-0.9

Other currency movements during the quarter ending 28.02.18 (%)

Currency	Quarter Ending 28.02.18
US Dollar / Canadian Dollar	-0.7
US Dollar / Yen	-5.1
US Dollar / Euro	-2.6
Swiss Franc / Euro	+1.5
Euro / Yen	-2.6

Significant Commodities (US dollar terms) 30.11.17 - 28.02.18 (%)

Currency	Quarter Ending 28.02.18
Oil	+5.3
Gold	+2.9

MARKETS

Overall, international equity markets have shown little change over the quarter. There was some weakness in February and volatility increased sharply following a long period of low volatility. In local currency terms, the FTSE All World Index returned +1.8%, in sterling terms +1.2%, in US dollar terms +3.0% and, in euro terms, +0.7%. Looking at local currency returns first, the stand out markets on the positive side were the FTSE All World Latin American Index which returned +12.4%, the FTSE All World All Emerging Markets Index +6.6% and the FTSE All World Asia Pacific ex Japan Index +4.0%. The FTSE USA Index also showed an above average return at +3.1%. On the negative side, the FTSE Japan Index and FTSE All World Europe ex UK Index both returned -1.2%, whilst the FTSE UK Index returned -0.7%. Turning to the sterling adjusted returns, those indices showing above average returns in local currency terms continued to do so. The FTSE All World Latin American Index returned +11.5%, the FTSE All World All Emerging Markets Index +6.7% and the FTSE All World Asia Pacific ex Japan Index +3.2%. The FTSE USA Index's return was marginally above average at +1.3%. Japan and Australia also moved into above average return territory with the FTSE Japan Index returning +1.8% and the FTSE Australia Index returning +2.5%. Although European currencies rose against sterling, the FTSE All World Europe ex UK Index still returned a negative performance of -0.5%. Even though sterling was generally higher during the quarter because of US dollar weakness, thus dragging down the performance in sterling terms of the FTSE All World Index, the FTSE UK Index still underperformed that index.

There was a noticeable increase in yields on bonds as measured by benchmark ten year government bonds. In the case of the UK, the gross redemption yield rose by 20 basis points to 1.59%, in the case of the US Treasury Bond by 54 basis points to 2.93% and in the case of the German Bund by 24 basis points to 0.62%. In the case of the Japanese Government Bond, the gross redemption yield remained unchanged at 0.04%.

By the standards of some recent quarters, foreign exchange movements were relatively muted. Against the US dollar, sterling strengthened by 2.0% and against the Canadian dollar by 1.3%, but against the yen it weakened by 3.1%, against the Swiss Franc by 2.1%, against the Australian dollar by 0.9% and against the euro by 0.6%.

In the commodity markets, oil, as measured by Brent Crude, rose by 5.3% and gold by 2.9%.

ECONOMICS

January and February of this year have offered two very contrasting pictures of the investment world. January continued a trend that has run for at least a couple of years where there has been more good economic news than bad, the sense that the troubles of the past decade have continued to fade and that the prospect of companies improving their top and bottom lines has remained very real. Market movements in February presented a very different commentary with violent moves downwards at the start of the month followed by a shallow recovery. For world equities, January was an up month, February a down month, but, overall, markets are in positive territory over the two months to the end of February in local currency terms. We will not know for some months whether this episode of extreme volatility, coming after a long period of exceptionally low volatility, is a pre-cursor of a new direction in markets or an aberration from a continuing direction of travel.

In support of this observation it is worth considering two different interpretations of the situation. Firstly, in economic terms, the world economy continues to grow healthily and, in terms of the business cycle, we remain in a positive phase of growth which, in turn, is supportive for risk assets. This being the case, February's bout of volatility was an episode where machine trading led self-feeding falls causing spectacularly fast selling where, for a short period, a sense of measure was lost. The alternative conjecture is that this was a death rattle of the bull market as the business cycle peaks, meaning we would naturally expect sentiment to deteriorate and the pessimists to start to outnumber the optimists.

To the budding economist the direction of market movements over the last few years up until the end of January corresponds specifically to one particular phase of the business cycle which is the growth phase. The business cycle is stylised as a repeating sine wave where a period of economic growth will be reflected by rising prices of risk assets which will eventually lead to rising interest rates to quell excess demand. A tipping point will then be reached when interest rates peak, confidence starts to ebb, asset prices fall, economic contraction appears and interest rates are cut to stimulate demand, leading to relatively accommodative monetary conditions which lead to a restarting of the growth phase of the cycle. This is the textbook model and the reality does not always look like this. The symmetry of the cycle, the varying timescales of different phases and the fact that different parts of the economy or countries may be in different stages at the same time all need to be considered. It is also true to say that past (economic) performance is not necessarily a guide to future performance.

It is easy to marry the events of the last ten years with the model outlined above, though extenuating circumstances apply; for the sake of simplicity focus is on the UK economy. The Blair/Brown years were a period of steady economic growth, where GDP rose by above 2% per annum, inflation rose manageably as the decade progressed and interest rates rose from 4% in 2002 to 5.75% in 2007. In this case the gently improving business cycle was abruptly dragged past its highest point by the sub-prime collapse in the U.S. and the consequential effect it had on the UK banking sector. The rest is history but needless to say the period of economic decline taking the economy to the bottom of the cycle was short and jarring. By March 2009 interest rates had reached 0.5% and the destructive effects of the banking crisis led to a broad and deep fall in the value of risk assets. Whilst that is particularly significant in the context of this memorandum this was a secondary effect and it should not be forgotten that the severity of the crisis meant that it is likely that the country's entire banking system would have collapsed without the epoch-defining intervention of the Bank of England and the Treasury.

From that lowest economic point almost 10 years ago the economy has been in a prolonged and shallow recovery phase where ongoing central bank intervention has plugged some gaps left by an absence of confidence and a recovering banking system. The banking system has largely normalised now and, excepting any possible contributory effects from Brexit, confidence has improved considerably over this phase. Returning to the initial question relating to where we are in the business cycle, many indicators point to the growth phase being ongoing. Inflation, peaking above 5% in 2011, before troughing around zero in 2015 and 2016, is now above target at 3% and inviting higher interest rates and with bank base rate at ½% it would seem highly improbable to believe that they have peaked. In summary, the British economy grew steadily, building up to the financial crisis, the economy contracted sharply over a period of two years before bouncing back and returning to growth, albeit at a generally lower rate than pre-crisis. The pattern of UK unemployment supports this simple model too, remaining around 5% through the first 8 years of the century, before rising rapidly to peak at 8.5% in 2012 and then steadily falling to the current low level of 4.3%. Perhaps the most atypical aspect of the current near decade long recovery is that there has been a near total absence of a feel good factor at any point. There are, of course two factors which accompany the economics of this time, which have never been seen previously. Firstly, the application of monetary policy through unprecedented levels of quantitative easing and, secondly, Brexit. There are risks around the withdrawal of the former and the adoption of the latter.

Returning to the business cycle model, it is worth trying to marry the rise of interest rates, to prevent an overheating economy, to the current situation. Monetary policy, as is typical in the growth phase, has been used as a tool to stimulate growth by encouraging lending, to target excess unemployment and, at times, deal with below target inflation. There is a question around the effectiveness of this policy in increasing investment lending but it cannot be argued that the unemployment situation has not improved. Inflation is fickle but has remained above the 2% target for over a year and more recently has hit 3%. Productivity remains disappointing and real wage growth is below the ideal level.

There are several pertinent points to make at this stage. Firstly, the growth phase, measured in years, has been very long; in comparison with historic growth periods nine years is very long but, when measured not in years but in GDP growth, the period of expansion is less remarkable. Secondly, the 'reluctant bull market' expression seems to have applied for the whole of the current phase of the business cycle, though the reasons why may have changed. It may be that the trauma of the financial crisis has lingered long after the event manifesting itself as a sense of denial at the good economic progress made.

Returning to the events of early February, there is an irony that the 'flash crash' in February was, seemingly, triggered by good news not bad. Figures from the United States at the beginning of the month showed that wage growth had risen to 2.9%, a higher figure than had been expected. On the basis that the business cycle dictates inflationary pressures and, hence, the response, it meant that the policy route forward would now involve a more aggressive trajectory of higher interest rates. To the pessimists this could point to the start of the end. Going further back to January, the joke at Davos was that attendees were split into those who thought world economy was doing well and those who thought it was doing too well. This may seek to make light of a situation that is most welcome and contrasts with the mood of earnest concern that normally accompanies this winter summit. It is always important to focus on the economic fundamentals and it is generally accepted that, in terms of the economic position, we start 2018 in a better position than any year since before the great financial crisis. That is a bold assertion but growth is looking pretty good with forecasts improving, growth is more evenly spread than it has been, unemployment in most key economies is low and falling and the risks of deflation, something that was a real worry a couple of years ago, have abated and inflationary pressures have returned, though still remain subdued, given where monetary policy finds itself. Cherry-picking good news from the first six weeks of the year has been quite easy with industrial demand in Europe high, Japanese exports at record levels, the U.S. enjoying the stimulus of a massive tax break and even the United Kingdom continues to demonstrate that reports of its death have been grossly exaggerated, defying for the time being, at least, the apocalyptic predictions of what would happen to the UK economy if the country voted to leave the E.U.

It is difficult not to be struck by certain aspects of the market movements of the beginning of February. On Monday 5th February the Dow Jones Industrial Average registered a downward move of around 1,600 points, the largest intraday point drop ever, before ending the day down a mere 1,175 points. Needless to say this attracted a great deal of news coverage and, in a similar way to measuring periods of economic growth in years and then GDP growth, whilst the absolute number was impressive, the market rout was not even in top 50 in percentage terms and was only the 25th largest since 1960. This index, the measure of some of the largest companies in the United States, though not as representative as the S & P 500 Index, dates back to 1896. Analysts have been saying for many months that markets have been long due for both a correction and a return to volatility. Traders measure market volatility in a variety of ways but one of the most common and agreed upon is an index known as the VIX which, for the last few years, has registered low volatility. We have had short periods of volatility such as in reaction to the downgrade of the United States' sovereign debt in 2011, the threat of downgrade in 2013, the 16 day 2013 government shutdown and a few weeks of selling in 2016. Otherwise the markets have been unusually calm. In the ensuing analysis of February there has been much focus not on the amount the market fell but the speed of both the fall and the rebound which would suggest that this is a market generated phenomenon. This is not to say that such events should be discounted as just markets doing their thing but, rather, it may say something about the elemental forces that now contribute to market movements. It looks likely that it was program-driven trading dominating the selling patterns during those short bursts of high volatility with software driven trading recognising exploitable falls that could be bought into, further compounding the drop. It is probable that humans could not and would not drive the share price of leading companies such as Boeing to fall from $335 to $321 and recover back to its original level in the space of fifteen minutes. Boeing shares closed at $318.60, having earlier in the day been as high as $350.

This is not without precedent and this will happen again. Banks, hedge funds and other traders now hire the best experts in artificial intelligence to create software systems that are capable of auto-learning. Their job is simply to rake through vast amounts of historic data and to look for patterns of movements. These movements may be small and fleeting but their key trait must be that they are predictable. Small and fleeting can be overcome by using derivatives, making huge bets and/or repeating trades thousands of times per hour. On days like this we may be given a lesson in how sensitive such programming can be to changes in initial conditions. Humans may provide a natural circuit breaker, being unwilling to sell down a stock so quickly when no news pertinent to that stock has appeared. Machine traders may continue to see momentum trades right up to point there is a reversal and then see momentum trades back the other way. The trading is opaque, much may happen off market and, in most cases, profit and loss is not reported.

With the advent of high frequency trading and through ETFs the ability to buy and sell tranches of the market or the whole market in high volumes in small fractions of a second the issue becomes that the market ceases being the summation of a multitude of views on individual securities but a view on being long the market or short the market or perhaps moving from one view to the other within seconds and perhaps the view may change thousands of times a day. If this is a correct summary of the situation then there is a chance that we will see more powerful anomalies disrupting the market. It should be remembered that markets do tend to have long periods of low volatility interspersed with short periods of very high volatility but the speed with which they fell and then recovered can only be explained by software and passive trading that leads to blind selling and blind buying.

Another concern is that we never get to the bottom of what causes these crashes. The intraday ‘flash crash’ of 6th May 2010 saw a 1,000 point dive and the reasons behind it have never been unravelled. Various reports and analyses have been written but none has reached any meaningful conclusions. The U.S. Securities and Exchange Commission, which has responsibility for its stock exchanges, published a 106 page report on it but its conclusions were limited.

February seemed, more than anything, a reaction to employment news in the US. It wasn’t the famed non-farm payrolls which gave the number of new jobs created as 200,000, a healthy enough figure, but, rather, it was earnings growth. The data showed that there was a 2.9% average hourly earnings increase in January compared with a year earlier. The December figure was 2.5%. This was a surprise, being above estimates and led many to think that we were, in fact, further along in the business cycle than previously thought with pressures building in a thin labour market and it would manifest itself as a faster rise in interest rates. This reaction to news is reminiscent of the early days of Ben Bernanke at the Federal Reserve when good news was taken as bad news. On one level, being closer to the peak of the business cycle is concerning for investors and, on another level, higher interest rates have, perhaps more in academic terms, a direct effect on asset valuations. This is more commonly applied to bonds and that has most definitely been the case recently but can be applied to shares as well. In owning a share in a company the investor has a claim on a flow of future profits. If the current interest rate is 0% then those future cash flows (dividends and any future capital gain) have a certain value which can be discounted back to a current share price valuation. If the interest rate suddenly rises to 10% then those future cash flows are less attractive and so the current value, or share price, of those future cash flows is much lower. In February’s example we did not see any change in interest rates but we just experienced a perceived change in the expectation of the pace of likely future interest rate rises which, when put in those terms, doesn't suggest much difference but, with rates so low at present, sensitivities are very high and, as it appears for the time being, exaggerated by the prevalent types of trading in the market.

Not all of this rout requires much in depth analysis. Markets are jittery as bond yields in some markets have been surging as bond prices fall and stock valuations are higher than they have been. From that perspective we should not be surprised by episodic negative periods, and this memorandum has been making that warning for some time, but the speed at which the market fell was something to behold. JPMorgan recently estimated that only 10% of the volume of stocks are now traded daily by individuals making active choices about what to buy or sell. That figure may be low but we do know that a large portion of all stocks are owned in Exchange Traded Funds (ETFs) that represent a passive basket of stocks and that a number of banks and hedge funds command tens of billions of dollars investing not just in those ETFs, but in derivatives (instruments such as options or futures) that are structured to generate a multiple of the returns of those ETFs, or the inverse. They may sit waiting for days when activity accelerates, pegged to programs that buy and sell based on how quickly prices are moving. The result is a market that is often placid but can take a slight input and turn it into a selling vortex and then reverse direction and become a buying hurricane. This indicates a move from picking stocks that you favour and selling ones you like less, to being long the market or short the market or perhaps moving from long to short in fractions of a second and thousands of times a day.

As investment managers it is important to have a view on where we are in the business cycle and this is especially the case after months like February. The central question is whether economic conditions remain favourable for companies to continue to grow their top and bottom lines or have we seen compelling evidence that suggests it's time to liquidate portfolios and move to cash? There are certain common and expected signs of the end of the growth phase of the business cycle. Furthermore in a rational market, somewhere we don't always find ourselves, it would be reasonable to expect that the end of a bull market would coincide with that point. The preconditions would include troughing unemployment, rising wage and price inflation, negative earnings per share revisions and yield curve inversion. Looking at key markets it would appear that the United States is closer to meeting these conditions than other leading economies but there remains some spare capacity all the same, something new Federal Reserve chairman Jerome Powell highlighted in his testimony to the Senate. The employment market has changed to the point that historic measures of unemployment are now less accurate indicators due to factors such as underemployment, increased mobility, the increased participation of women and the 'gig' economy. Measures of inflation are rising but, given the ongoing effects of quantitative easing, are still surprisingly low. The last company reporting seasons in the U.S. have been strong, compared with historic averages, consumer spending is strong and the stimulatory effect of the U.S. tax cuts has been seen by Wall St quicker than Main St. Merger and Acquisition activity has also been strong reflecting confidence.

A year ago there was a great deal of concern regarding the potential impact of the new U.S. President and some significant national elections in Europe. In that respect political risk is now less significant than a year earlier and, whether we like it or not, the likely outcome for the United Kingdom will not change the direction of world growth. Ignoring impossible to price threats such as North Korea means we return to, what is in Meridian's view the most significant area of risk, a rising interest rate environment, and this returns us to the turbulent first week of February as it appears that fresh economic data relating to the future path of rate rises set about this trading frenzy. It remains our view that equities are still supported by the economic outlook and that interest rate rises will accompany ongoing economic growth. Europe has now experienced 19 quarters of consecutive economic growth and the United States grew at an annualised 2.5% in the last quarter of 2017. It would not be unreasonable to see a positive contributory effect to this figure from the recent tax breaks when they trickle through to the real economy.

It will be important to monitor other asset classes and understand how their performance may impact the stock market though, in this most recent period of disruption to equity markets, there was little overspill into fixed interest or foreign exchange markets. There remains a heightened risk that a sharp rise in inflation will have to be met with interest rate rises and, whilst some overshoot of targets could be accommodated in those circumstances, interest rates could rise in a way that becomes uncomfortable for property markets, but particularly bond markets. So far yields have risen from the historic lows in just about the best way possible - consistently and without too much drama. On the last day of February U.S. 10 year Treasuries were yielding 2.93% a long way from their all time low of 1.36% in January 2016.

Disruption to markets has been noticeably absent over recent years but nobody has suggested that volatility would never return and, that being the case, the league table of threats is constantly rewritten by analysts, economists and the press. Alongside unpredictable politicians, changing monetary policy and debt, markets present a threat to themselves. It is the case that the short term belongs to traders and the long term belongs to investors though, when markets are shaken so violently by short view trading, this can change sentiment towards an asset class, particularly at this time. It is important to look beyond this and remain wedded to the economic picture, which provides adequate grounds to remain invested. There are some assertions that frequently resurface in this monthly memorandum and one such statement is that it is not possible to be an equity investor in circumstances where risk is absent. February has been a reminder of this and it is more likely than not that aftershocks will be felt for some time. Equity investors, as opposed to equity traders, will need to maintain their five year investment horizon and continue to accept the possibility of negative quarters.

We continue to monitor closely the political risk in various countries, whether that be an escalation in anti-trade barriers such as U.S. threatening to impose tariffs on steel and aluminium imports and the inevitable response it would generate, the indecisive Italian general election which offers many permutations of future coalitions, some being more eurosceptic and, of course, the risks around politics in the U.K. Thinking purely in terms of the impact on investment markets we remain very concerned that the current situation in the U.K. could change, leading to a snap General Election and the possibility of a very left leaning Labour Party coming to power. If that outcome were to look likely, and where our mandate allows, we would seek to reduce exposure to companies focused on the U.K. economy, particularly those where there is a threat to their ownership structure. In any case, unless mandated otherwise, the majority of our client portfolios are invested outside the U.K. for diversification purposes and to protect against the elevated risk in the U.K.