meridian

ASSET MANAGEMENT (C.I.) LIMITED

## Investment Memorandum

It has been a quarter of very little movement overall but some volatility because of tapering, emerging markets and, most recently, the Ukraine. The divergence in performance between the developed and emerging markets continues. Top quality bonds have had a satisfactory quarter whilst, in the currency markets, sterling and the Swiss Franc have stood out. Gold, having experienced a torrid time, has made some recovery.

The tables below detail relevant movements in markets :

## International Equities 29.11.13 - 28.02.14

| Total Return Performances (%) | | | | |
|---|---|---|---|---|
| **Country** | **Local Currency** | **£** | **US$** | **€** |
| Australia | +2.4 | -2.0 | +0.2 | -1.2 |
| Finland | +1.2 | +0.3 | +2.6 | +1.2 |
| France | +3.7 | +2.8 | +5.2 | +3.7 |
| Germany | +2.9 | +2.0 | +4.4 | +2.9 |
| Hong Kong, China | -0.7 | -3.1 | -0.8 | -2.2 |
| Italy | +7.1 | +6.2 | +8.6 | +7.1 |
| Japan | -3.9 | -5.8 | -3.6 | -5.0 |
| Netherlands | -0.4 | -1.2 | +1.1 | -0.4 |
| Spain | +2.9 | +2.0 | +4.4 | +2.9 |
| Switzerland | +3.4 | +3.7 | +6.1 | +4.6 |
| UK | +2.9 | +2.9 | +5.3 | +3.8 |
| USA | +3.8 | +1.5 | +3.8 | +2.4 |
| Europe ex UK | +3.5 | +2.8 | +5.2 | +3.7 |
| Asia Pacific ex Japan | N/C | -3.6 | -1.4 | -2.8 |
| Asia Pacific | -2.0 | -4.7 | -2.5 | -3.9 |
| Latin America | -9.8 | -12.8 | -10.7 | -12.0 |
| All World All Emerging | -4.0 | -7.3 | -5.1 | -6.5 |
| The World | +2.5 | +0.4 | +2.7 | +1.2 |

*Source* FTSE World Indices

FT Government Securities Index All Stocks (total return) : +1.0%

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

| Currency | 29.11.13 | 28.02.14 |
|---|---|---|
| Sterling | 2.77 | 2.72 |
| US Dollar | 2.75 | 2.66 |
| Yen | 0.61 | 0.59 |
| Germany (Euro) | 1.70 | 1.63 |

**Sterling's performance during the quarter ending 28.02.14 (%)**

| Currency | Quarter Ending 28.02.14 |
|---|---|
| US Dollar | +2.2 |
| Canadian Dollar | +6.3 |
| Yen | +1.8 |
| Euro | +0.6 |
| Swiss Franc | -0.7 |
| Australian dollar | +4.2 |

**Other currency movements during the quarter ending 28.02.14 (%)**

| Currency | Quarter Ending 28.02.14 |
|---|---|
| US Dollar/Canadian Dollar | +4.0 |
| US Dollar/Yen | -0.4 |
| US Dollar/Euro | -1.6 |
| Swiss Franc/Euro | +1.3 |
| Euro/Yen | +1.2 |

**Significant Commodities (US dollar terms) 29.11.13 - 28.02.14 (%)**

| Currency | Quarter Ending 28.02.14 |
|---|---|
| Oil | -0.6 |
| Gold | +7.0 |

# MARKETS

It has been a quarter of little change in equity markets. A significant dip in January was largely recovered in February. For the quarter, the total return on the FTSE World Index in local currency terms was 2.5%, in sterling terms 0.4%, in US dollar terms 2.7% and in euro terms 1.2%. If we look at individual markets, apart from Japan, the performance was broadly similar in local currency terms. The FTSE USA Index returned 3.8%, the FTSE Europe ex UK Index 3.5% and the FTSE UK Index 2.9%. The FTSE Japan Index, however, showed a negative return of 3.9%. As before, there was weakness in emerging markets with the FTSE All World All Emerging Markets Index returning -4.0% in local currency terms whilst the FTSE Latin America Index returned -9.8%. Given that sterling, except against the Swiss Franc, was generally stronger over the quarter, the returns in sterling terms reduced accordingly. The sterling return on the FTSE USA Index was down to 1.5%, on the FTSE Europe ex UK Index down to 2.8% and on the FTSE Japanese Index down to -5.8%. The FTSE Asia Pacific ex Japan Index, which was unchanged in local currency terms, returned -3.6% in sterling terms. The return on the FTSE Latin America Index fell to -12.8% and on the FTSE All World All Emerging markets Index to -7.3%. The FTSE Australia Index, which returned 2.4% in local currency terms, returned -2.0% in sterling terms.

High quality international government bond yields, as measured by the ten year benchmarks, drifted lower over the quarter. For UK government bonds, the gross redemption yield fell 5 basis points to 2.72%, for US Treasuries by 9 basis points to 2.66%, for Japanese government bonds by 2 basis points to 0.59% and for German Bunds by 7 basis points to 1.63%.

As we mentioned above, in the foreign exchange markets, sterling was generally stronger, the exception being against a firm Swiss Franc against which sterling fell by 0.7%. Against the Canadian dollar, sterling rose by 6.3%, against the Australian dollar by 4.2%, against the U.S. dollar by 2.2%, against the yen by 1.8% and by the euro against 0.6%.

In the commodity markets, oil, as measured by Brent Crude, fell by 0.6% whilst gold recovered 7.0%.

# ECONOMICS

Just when international equity markets have recovered from January's dip caused by concerns about emerging markets, the market faces a major political issue, Ukraine. At the time of writing this at the beginning of March, it is too early to speculate on the outcome of the crisis. It is very difficult to formulate a market judgement based on political events. There are many political issues around the world, perhaps notably in the Middle East, but they tend not to affect markets other than in the short term. However, that is not to be complacent. This time it could be different.

However, the resilience of international equity markets is impressive and it suggests that the factors supporting the markets are still at play. Absent unexpected political or economic setbacks of a more permanent nature, it is expected that the world economy will put up a better performance this year and that, overall, corporate earnings and dividends will increase, which, of course, they need to given the extent of last year's rise in stock markets. The big support to the stock and bond markets' gains since the financial crisis has been the application, almost everywhere, of ultra loose and unorthodox monetary policy. With very low or no interest being earned on bank deposits, the attractions of alternative asset classes with better yields have appealed to those for whom equities and, possibly, bonds were not previously considered on alternatives. With central banks in developed countries still signalling a continuation of very low interest rates at the short end of the yield curve, investors are not taking too many risks at present in basing at least part of their investment policy considerations on the likely course of short term interest rates. Further along the yield curve, it is more difficult for the central banks to control interest rates but, at the moment, the level of longer term gross redemption yields is not causing problems for equity investors in terms of traditional yield comparisons. However, there is no room for complacency here because, as we have said many times before, bond yields are unrealistically low. The transformation to more traditional yield levels together with the gradual reining in of quantitative easing will be a real challenge to international equity markets let alone bond markets.

If we go back to January's temporary fall in international equity markets, the link between weakness in some of the emerging markets and the start of the Federal Reserve's tapering policy becomes clear. When the Federal Reserve and other central banks originally instigated their very loose monetary policy there was a significant inflow into emerging market bonds to capture the higher yield and the flows helped to strengthen some of their currencies. That was fine whilst it lasted but when the start of the Federal Reserve's tapering programme was signalled last year, and has just recently been triggered with two months reductions' of US$10 billion per month to take the current level of quantitative easing down to a still massive US$65 billion a month, many investors considered that it would help to raise the value of the US dollar. That being the case, those emerging markets with poor fundamentals suffered. The trigger was the sharp fall in the Argentine peso as the central bank, running down reserves, withdrew support at the previous level. All the fundamentals for Argentina were poor with high levels of political and economic risk and a large current account deficit. But, elsewhere, investors focused largely on countries' current accounts. Current account deficits need to be financed. If there is confidence in a country, foreign inflows of capital can bridge the gap but, in looking for weakness in a country, investors will focus on this issue amongst others such as the level of foreign currency reserves. As tapering increases, quantitative easing eventually stops in the USA and elsewhere and it is then reversed, there will be challenging times for stock markets and for some of the emerging markets. But it is important to look at the whole picture. Many of these economies still have much higher potential growth rates than those of developed economies and fashions amongst investors will change. So, economics is important. It can help to flag up items of data which point to vulnerabilities which investors can factor into their investment decisions. As with a number of eurozone countries, a number of emerging markets did not use the good times to undertake the necessary structural reforms needed to improve their long term growth potential.

Generally speaking, international equity prices last year increased at a faster rate than corporate earnings growth, something like four times in the USA, and, by definition, became more highly valued, not to a level which is dangerous in our opinion but which requires higher levels of earnings growth to push forward share prices further this year. For this to happen, however, there must be confidence in the business sector and this has generally been lacking. Companies have felt inhibited from investing more than they have to by economic and political concerns and these still continue. In the USA, the uncertain effects of the political stand off between Congress and the President and the budget and debt ceiling, as well as the costs of Obamacare, have dented business confidence. In the UK, it has been the continuing effects of austerity, necessary to tackle the UK's huge debt problem, and now increasing political worries as the next General Election draws near in 2015. In the eurozone, the poor economic background and lingering uncertainty over the currency worries are holding back investment. In many ways, the best conditions are in Japan where the aggressive monetary and fiscal policies created by "Abenomics" and the more competitive exchange rate for the yen, should provide Japanese companies with more propitious circumstances for investment. With inflation likely to be positive rather than negative, that removes one impediment to investment since holding off, depending upon the type and profile of investment, would probably cost more. The one uncertainty is April's rise in consumption tax from 5% to 8%. In the short term, shareholders have benefited from companies returning cash to them either by increasing regular dividends, paying special dividends or returning capital, or by share buybacks. Although there is a debate about the value of share buybacks, such as whether the money used could be better spent on, say, capital investment, the theoretical benefits are clear, particularly with current very low interest rates. A reduced share count, depending upon the mathematics of the situation, can raise earnings per share. Particularly for US companies, they are used to avoid or mitigate dilution arising from the exercise of share options. A lower share count increases the scarcity value of a company's shares which may cause them to rise. If done on the correct mathematical basis, earnings per share will rise leading to a more attractive rating. These are theoretical benefits and, as we say, are controversial with some academics and investors but it has been a noticeable feature of the way in which companies have been returning value to their shareholders in recent times.

However, there comes a time when companies have to invest. During the recovery from the financial crisis and recession, companies' profits received significant assistance from cost reductions rather than revenue growth but there is a limit to how far this can go without damaging a business in terms of investing for future growth. For the recovery to be sustainable in countries like the USA, UK and Japan, we need to see business investment and exports driving growth rather than, depending upon which country one is talking about, consumption, the housing market and government spending. On the other hand, in a country like Germany, which runs a vast current account surplus, the ideal situation would be for consumption to grow which would benefit struggling eurozone countries and reduce intra eurozone current account imbalances. In China, the authorities are trying to scale back incredibly high levels of fixed asset investment and emphasise consumption and de-emphasise exports. Whilst it would be too much to expect of the eurozone that there is a meaningful increase in business investment, there are tentative signs of business investment expansion in the USA and UK. In the USA, even though the latest fourth quarter estimate of GDP was revised down, there was some encouraging news on business fixed investment in those figures. The same was true for the UK.

One of the concerns that has developed further over the last quarter in the eurozone is about the onset of deflation, something which we have not had to worry about in the past unless we lived in Japan. Because uncompetitive eurozone countries cannot devalue their way out of uncompetitiveness any longer, the pressure is to have internal devaluations, i.e. trying to restore competitiveness by cutting costs in areas like labour. Pay cuts affect internal demand and help to drive down prices. Some may say this is a good thing. One of the original claimed benefits of the euro was that it encourages economic convergence. That is true, but what it did not anticipate was the divergence which helped to cause the current problems. Cost discipline went out of the window in several countries, damaging current accounts and rendering the countries vulnerable to a failure to finance their deficits. The convergence which they are now being asked to undertake risks a spiral of economic decline with deficient demand in these countries leading to downward pressure on price levels. For those of us who have lived most of our lives at a time when inflation was a problem, worrying about a deflationary environment feels almost ungrateful. But, if deflation were to grip the eurozone, it would be a problem with bad side effects. Falling price levels would adversely affect demand as customers refrained from buying discretionary purchases or for business non essential purchases, all in the belief that they could be bought more cheaply. This is a recipe for economic recession. The other major problem is that deflation raises the real value of liabilities so that defaults on bonds, loans etc. become more common, thus threatening the banking system and more economic problems. It is the opposite of what we are used to where inflation has eroded the real value of conventional fixed interest securities and has been of benefit to borrowers and the detriment of lenders. Now it is the other way round, except that the benefit for lenders would almost certainly be tempered by an increasing bad debt experience. At present, the eurozone inflation rate is 0.8%, not a big margin of comfort but we would expect the ECB to do whatever it is possible to do to avoid being cast in this situation.

Whilst discussing the EU, and the eurozone in particular, the European Commission has come out with its latest economic forecasts highlighting its view that the EU recovery is firming. Its latest forecast for the eurozone is for growth of 1.2% in 2014 following a contraction of 0.4% in 2013. Its forecast for 2015 is 1.8%. For the EU as a whole, it foresees growth of 1.5% this year and 2.0% next year against growth of just 0.1% last year. Its forecast for the world economy is 3.6% growth this year and 3.9% growth next year against growth of 2.9% last year. For the four largest economies in the eurozone, Germany, France, Italy and Spain, for this year, the EC expects above average growth, relative to the eurozone, only from Germany at 1.8%. For France, the forecast is 1.0%, for Italy 0.6% and for Spain 1.0%. Whilst all these figures represent an improvement on 2013, they are still well below what is needed to propel meaningful growth in the eurozone which will enable the debt problems to be addressed. If we expand the universe to look into the wider EU which, we note above, is expected to show a faster growth rate than the more limited eurozone universe, we see some significant countries expected to perform rather better than the leading eurozone ones. If we look at the UK, Sweden and Denmark, we see expected growth rates of 2.5%, 2.5% and 1.7% respectively, all well above the expected eurozone average this year. For next year, Denmark is expected to grow by 1.8%, just 0.1% higher than this year, the U.K. by 2.4%, 0.1% lower than this year, and Sweden by 3.3%, considerably up on this year's 2.5%. Is it a coincidence that some of the significant non euro members of the EU are performing better? We think not.

With so little growth in the eurozone, the debt dynamics do not look good. A false sense of security seems to have taken hold of the eurozone and investors have agreed with this as yields on the troubled eurozone countries' bond markets have fallen sharply. The trigger for this was the President of the ECB's statement back in 2012 that the ECB would do whatever it took to save the euro, using the Outright Monetary Transaction ("OMT") scheme whereby the ECB would buy eurozone government bonds. So far, not one single bond has been bought and the recent German Constitutional Court decision, in which it cast doubt on the scheme's legality, creates uncertainty. Of the largest countries in the eurozone, France remains a concern with low growth, poor public finances and the need to make major structural reforms to improve long term growth prospects. These are going to be difficult to achieve without significant public opposition.

Overall, the recent Purchasing Managers Indices data for the eurozone have been slightly in positive territory. For manufacturing, the latest figure is 53.2 and for services 52.6. Whilst Germany's respective readings of 54.8 and 55.9 are quite strong, those for France are in negative territory at 49.7 and 47.2 respectively. That implies economic contraction. Italy, itself a concern because of its very high outstanding level of public debt to GDP (over 130%) has readings of 52.3 and 52.9 respectively.

So, we repeat the view that the eurozone crisis has not been resolved and that any complacency is not justified. One only has to look at the EC's forecast for eurozone unemployment to wipe away any such complacency. The forecast is for 12.0% this year and 11.7% next year and, of course, in the most severely affected countries, the levels of unemployment are shocking. So, for 2014, the EC forecasts unemployment in Greece of 26.0%, in Spain of 25.7% and Portugal 16.8%. These very poor economic statistics do not deter us from investing in eurozone companies. Many of them have the ability to avoid the worst of the difficulties in the area through the geographical diversification of their business and, as the table at the beginning of this review shows, the area has performed well.

As this is written, Wall Street is around record high levels and has shown impressive resilience. Besides the main driver of very loose monetary policy, which is a market issue worldwide, corporate earnings growth, M & A activity and, as we talked about earlier, shareholder friendly returns (dividends and share buy backs), have all helped. The absence of the sort of political drama we had in 2013, has also been supportive. The market shrugged off the expected downward revision of the final quarter of 2013's GDP from 3.2% to 2.4%, largely because there was some more encouraging news on business investment which, as we discussed earlier, is highly desirable as a catalyst for further economic growth. February's ISM Purchasing Managers Index for the manufacturing sector partially recovered January's possible weather related fall and rose from 51.3 to 53.2. On the other hand, the PMI for the non manufacturing sector fell from 54.0 to 51.6, so a mixed picture here but, overall, slightly in positive territory. Unemployment, watched closely for any possible implications for the Federal Reserve's monetary policy, ticked down to 6.6% in January from 6.7% in December. In its last statement, the FOMC said that growth in economic activity picked up in recent quarters and that, on balance, the labour market looked better although the unemployment rate is still elevated. It noted that household spending and business fixed investment advanced more quickly in recent months although there was some slowdown in the recovery in the housing sector. It reported that fiscal policy is restraining economic growth although the extent of the restraint is diminishing. Inflation is running below the FOMC's long term target rate but it points out that long term inflation expectations have remained stable. This was the meeting at which the FOMC announced a further reduction in the quantity of fixed interest securities purchased to US$65 billion. It indicated that if incoming information remained consistent with its view on the labour market and inflation, it is likely to continue its tapering programme, although it emphasised that asset purchases were not on a preset course. So, on the evidence available, it seems likely that the present policy of continued tapering will continue. If there are any unexpected negative surprises then the tapering programme can be temporarily suspended. In terms of what this means for the markets, we suspect that the idea of progressive tapering is now priced into the markets. Markets have reacted poorly in the short term to the earlier idea of tapering starting and then actually happening. It should now no longer come as a shock. In so far as it indicates a return to some semblance of normality in economic conditions, this should be welcomed. Quantitative easing was a sign of desperation but an economic recovery predicated on money printing is never going to be sustainable because it will ultimately lead to inflation with a consequent reversal of monetary policy, i.e. higher interest rates which will soon stifle economic growth. Although the US market has performed well, we see room for further limited improvement (more, should corporate earnings growth accelerate meaningfully) after its strong rise in 2013. In this context, the progress of company earnings will be important. At present, analysts are expecting accelerating quarter on quarter earnings growth as the year progresses.

It is still relatively early days to judge "Abenomics" in Japan. There are the three "arrows", monetary, fiscal and structural. The first two have been fired but the one which is worrying most Japan followers is the third one, structural. Too often, governments rely on central banks to do their part of the heavy lifting through interest rate changes but, loosening monetary policy (if that is what is happening) is no good if the stimulus it provides comes up against barriers to growth. So regulation of employment and product markets can negate any beneficial effects of central bank action. In the case of Japan, there are significant structural rigidities in the labour market which militate ultimately against younger workers. It looks unlikely that Mr Abe will be able to make the radical changes needed to be made. Product markets might also be difficult and, in the agricultural sector, the farmers are powerful campaigners. One of the central bank's targets is 2% inflation to eliminate the dangerous effect of deflation, which we outlined earlier. At present, the year on year CPI Nationwide Index is 1.4%. So, some progress has been made on this front. A sharp depreciation in the Yen has helped to stoke inflationary pressures and it will be necessary to build on this to change consumers' and businesses' mindset. Fourth quarter on quarter GDP rose at a rate of 0.3%, the same as in the previous quarter whilst fourth quarter year on year economic growth was 2.7%. The latest Nomura/JMMA Purchasing Managers Index was reasonably well into positive territory at 55.5. The government will be disappointed that companies do not appear to be using the weak currency to make their exports more competitive, rather they seem to be holding their prices so the economic "J" curve is not yet apparent. Those Japanese companies with big overseas exposure are benefiting from improved translation rates and we have seen some spectacular increases in profits arising from this benefit. The big challenge for 'Abenomics' is how Japanese consumers will deal with the forthcoming 3% hike in consumption tax. There will obviously be some precautionary buying and the true test is to whether this rise in consumption tax will damage the economy, as the one nearly twenty years ago did, or whether the expansionary effects of Mr. Abe's economic policies will overcome this. It is a high risk/high reward strategy for Japan. The rewards would be a stronger growth rate with benefits for Japan's very poor budgetary and outstanding debt situation. The risks would be that the consumption tax will choke off a rise in demand. With the Bank of Japan's balance sheet having expanded so much and growth below expectations, it could rattle the Japanese debt markets. With interest rates so low and some inflation in the system, you would expect Japanese bonds to be exposed to a big fall in prices.

China has confirmed its 7.5% target growth plan amid concerns about the Chinese economy slowing too much as it tries to rebalance the economy away from fixed assets, investments and exports towards consumption. Last year the economy grew by 7.7% but in line with recent years' experience. It is a delicate balance as the latest official China Purchasing Managers Index shows. For the manufacturing sector, it was barely in positive territory at 50.2, although it was a little higher for non manufacturing at 55.0. Worries over the banking sector in China as a result of overinvestment in fixed assets including property, and the dramatic growth for shadow banking sector which is estimated to account for about 30% of outstanding loans, makes the situation difficult to read but the Chinese authorities, more than most, probably have the ability to deal with most situations. As the number two economy and one which will eventually overtake the USA, more attention than ever is focused on China and, at a time of slow growth in the West, dragged down by the eurozone, significant Chinese growth remains important for the world economy. In a positive vein, it looks as if the new leadership is going to encourage the market sector and, if that is the case, this is likely to boost Chinese growth as businesses become freer. For the moment, the impact of Chinese growth on the world economy remains positive, notwithstanding the slowdown in growth which is likely against last year.

As we touched upon when we reviewed the EC's forecasts for the EU, the UK is a stellar performer (in relative terms) as the last year has confounded the economic pessimists. Nearly all the indicators show prospects to be positive for the UK. Of course, it has the benefit of not being shackled to the euro but the strong medicine which has been needed to start to address the horrific public debt problem shows that growth can be achieved even in such circumstances. Although it is not helpful to exporters, the strength of sterling indicates some foreign confidence in the UK, although part of the strength may reflect the belief that interest rate rises will occur sooner than expected. The latest Purchasing Managers Index survey for the manufacturing sector reads 56.9, a relatively strong performance, while that for the services sector is even better at 58.2, that for the smallest of the purchasing managers indices weights in the UK economy, that for construction, has been very strong at 62.6 as the house building sector has accelerated. The unemployment figure has been falling steadily and now stands at 7.2% which means that it is likely to reach 7% much earlier than the Bank of England had expected, although it is at pains to indicate that will not necessarily mean an interest rate rise. Fourth GDP growth was 0.7% over the previous quarter whilst the year on year rate was 2.7%. Our main concern about the UK is the development of a toxic anti businesses culture with populist attacks on businesses from politicians and other parties and damaging strategies proposed for perceived failings in the energy, banking and construction markets. At a time when the UK is performing relatively well, albeit from a low base, this will almost seem an own goal as foreign investors consider whether they should delay or avoid any possible UK investment. The energy sector is one which has been particularly affected by populist calls for price freezes and attacks on companies for making profits. At a time when the UK is facing a very delicate balance on energy supplies, none of this is likely to encourage foreign investment and may lead to energy shortfall. Business voices are becoming increasingly strident in the criticism of some of the proposals for the private sector and it would be foolish to ignore these as market factors as the next election approaches. The UK is increasingly being considered as an unstable and unpredictable country in which to invest. We have to temper our support for UK equity prices with this caveat.

In conclusion, we believe that the investment outlook is much as before. After double digit investment returns in 2013, it would be unrealistic to expect anything like the same level of returns. As we emphasised earlier, after the multiple expansion last year, we do need to see a reasonable level of corporate earnings growth this year and, as things stand, that is likely to be the case based on some improvement in economic conditions. But, as the volatility in markets in January and February have shown, they are susceptible to perceived bad news but can recover quickly. So, our best estimate is that, whilst there will be modest growth in international equity markets this year, there will be one or two negative quarters reflecting the amount of adverse political and economic news which could threaten. The Ukraine crisis is still in its relative early stages and we do not know what the outcome will be. However, when compared with bonds, which remain an area lacking attraction in our view, equities have the greater attraction.