meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

The relatively small movements in the indices shown below belie a highly volatile quarter which started badly in December but recovered in January and February. Sterling based investors will generally have seen a slightly negative quarter if invested internationally as sterling strengthened considerably. Bonds were generally stronger as money flowed into the sector when shares were weak and volatile. Oil and gold both rose over the quarter in US dollar terms.

The tables below detail relevant movements in markets :

International Equities 30.11.18 - 28.02.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+10.1	+2.9	+7.3	+6.7
Finland	+7.9	+4.1	+8.5	+7.9
France	+4.7	+1.0	+5.3	+4.7
Germany	+2.1	-1.6	+2.6	+2.1
Hong Kong, China	+13.6	+8.6	+13.2	+12.6
Italy	+7.8	+4.0	+8.5	+7.8
Japan	-3.1	-5.2	-1.1	-1.7
Netherlands	+4.5	+0.8	+5.1	+4.5
Spain	+4.0	+0.3	+4.6	+4.0
Switzerland	+4.4	+0.5	+4.7	+4.1
UK	+2.6	+2.6	+6.9	+6.3
USA	+1.6	-2.5	+1.6	+1.1
All World Europe ex UK	+4.3	+0.5	+4.7	+4.1
All World Asia Pacific ex Japan	+7.1	+2.2	+6.6	+6.0
All World Asia Pacific	+2.9	-0.8	+3.4	+2.8
All World Latin America	+6.0	+5.6	+10.1	+9.5
All World All Emerging Markets	+5.5	+1.7	+6.0	+5.4
All World	+2.5	-1.2	+3.3	+2.4

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +2.4%

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

Currency	30.11.18	28.02.19
Sterling	1.23	1.25
US Dollar	3.11	2.70
Yen	0.10	-0.02
Germany (Euro)	0.28	0.05

Sterling's performance during the quarter ending 28.02.19 (%)

Currency	Quarter Ending 28.02.19
US Dollar	+4.0
Canadian Dollar	+2.9
Yen	+1.9
Euro	+3.4
Swiss Franc	+3.9
Australian Dollar	+6.9

Other currency movements during the quarter ending 28.02.19 (%)

Currency	Quarter Ending 28.02.19
US Dollar / Canadian Dollar	-1.1
US Dollar / Yen	-2.0
US Dollar / Euro	-0.5
Swiss Franc / Euro	-0.5
Euro / Yen	-1.5

Significant Commodities (US dollar terms) 30.11.18 - 28.02.19 (%)

Currency	Quarter Ending 28.02.19
Oil	+11.3
Gold	+7.9

MARKETS

Although there were significant intra quarter movements, the actual outcome for the quarter is one of little change. In local currency terms, the FTSE All World Index returned +2.5%, in sterling terms -1.2%, in US dollar terms +3.3% and, in euro terms, +2.4%. In local currency terms, the only negative performance in our table was seen in Japan where the FTSE Japan Index returned -3.1%. The outstanding performances came from the FTSE Hong Kong, China Index, +13.6%, and the FTSE Australia Index, +10.1%. The FTSE All World Asia Pacific ex Japan, the FTSE All World Latin America and the FTSE All World Emerging Market indices all showed above average returns of +7.1%, +6.0% and +5.5% respectively. The FTSE USA Index underperformed this quarter, returning +1.6% in local currency terms. With sterling strong during the quarter there were significant changes in sterling adjusted terms with the FTSE UK Index return of +2.6% well ahead of the FTSE All World Index, -1.2%, which was dragged down by the FTSE USA Index, -2.5%. The weakness of the Australian dollar brought the sterling adjusted return on the FTSE Australia Index down to +2.9%, still a creditable performance.

Looking at the international government bond markets and taking the ten year benchmarks, there was little change in the UK government bond with the gross redemption yield up just 2 basis points at 1.25%. Elsewhere, yields fell. On the US Treasury, the yield fell by 41 basis points to 2.70%, on the Japanese Government Bond by 12 basis points to -0.02% and on the German Bund by 23 basis points to 0.05%.

As touched upon above, sterling was strong over the quarter as investors regarded a “no deal” Brexit as less likely. Against the Australian dollar, sterling rose by 6.9%, against the US dollar by 4.0%, against the Swiss franc by 3.9%, against the euro by 3.4%, against the Canadian dollar by 2.9% and against the yen by 1.9%.

In the commodity markets, oil, as measured by Brent crude, rose by 11.3%, whilst gold rose by 7.9%.

ECONOMICS

Markets are fickle things. The last calendar quarter of 2018 was a poor one for international equities as the FTSE All World Index showed a negative return of 12.4% in local currency terms (10.5% in sterling terms), yet in the first two months of calendar 2019, we see a positive return of 10.5% in local currency terms and 6.0% in sterling terms. As an aside, the recovery in markets so far this year has received much less media attention than the falls, accompanied by heightened levels of volatility, in the final quarter of 2018. This is an aspect of markets which we have often mentioned. Bad news is much more newsworthy than good news and the concern amongst investment managers must always be that some investors will be intimidated by market moves and media hype into taking investment decisions which could prove costly.

So why did international equity markets experience such a bad final quarter of 2018 which in the first two months of 2019 has been largely recovered? Has something significant happened? The potential for a full scale trade war between the USA and China, which could drag in other countries, was, and still remains, a serious threat to the world economy. Protectionism is unreservedly bad and it can be overt or covert. It puts sand in the wheels of trade, slows down growth, introduces economic inefficiencies and raises costs. So why do it? If we look at the USA first, it was undoubtedly a vote winner for President Trump. The idea of putting America first and saving jobs in industries like steel, which had been undercut by imports, played well in states he had to win and it did. President Trump says that he likes tariffs which represent an easy win. An area where China has annoyed many countries is in the field of intellectual property, which many feel it has gamed unfairly through its trade practices and disadvantaged industrialised countries. As foreign companies wait to gain a foothold in China, the price has been to share intellectual property. One policy that the USA and other countries have taken particular objection to is “Made in China 2025” which aims to give China technological dominance. This has put other countries on the alert. China has stopped talking publicly about it but it is a key discussion point in the trade talks as it suggests an unlevel playing field. But, in the cold light of day, politicians on an adrenaline rush caused by the hype of populist policies have to face reality about the economic effects of their policies. In the case of President Trump, he is facing re-election next year and he suffered a significant setback in the mid term elections last November when the Republicans lost control over the House of Representatives. Whilst there is no sense of predictability about US policy, the state of the US economy is bound to be an important issue in the election. At the moment, the US economy is performing well but companies are noting in their results some of the effects of tariffs and, if continued and extended as threatened, the outlook would worsen. Although unpredictable, one would assume, as a politician and businessman, that the President would recognise this and factor it into his negotiating tactics with a view to finding a satisfactory resolution to the issue.

But President Xi also has problems. The USA’s trade deficit with China in 2018 was US$382 billion, something which President Trump has obviously honed in upon, and it looks as if one of China’s offers is to buy more from the USA. However, in the tit for tat on trade when China’s exports to the USA are US$493 billion and imports from the USA just US$111 billion, the negotiating strength on imposing import tariffs is not strong. From a political point of view, with all the powers which President Xi has accumulated for himself since he came into office, comes additional pressure if things go wrong. The focus of the Chinese economy is moving away from fixed asset investment and exports towards consumption and services and, of course, the objectives of the “Made in China 2025” policy. So, whilst President Xi does not have to face the electorate, he has subtle pressures on him to keep the Chinese economy growing at a rate which can absorb people into work from the countryside. Against this background, a trade war which would affect the Chinese growth rate would be bad news.

As this is written, the USA has delayed a scheduled rise in tariffs from 10% to 25% on US$200 billion worth of Chinese goods which was due to come into force on the 1st March. The evidence of the stock market rise so far this year is that investors are more confident that common sense will ultimately prevail and an agreement will be reached. If that were to happen, it should give shares a boost because, at the end of the day, they depend upon economic growth for rising profits and the ability to pay increased dividends. The best assessment of the position is that the danger of a trade war which spooked markets at the end of 2018, has been reduced but not eliminated.

Whilst on the issue of protectionism, although this has not been an issue so far but might be a pointer to the future, there are signs of it becoming a development in the future in the EU. In a widely published ruling, the European Commission has blocked a merger of the rail units of Siemens AG and Alstom SA because of fears that it would stifle competition. The governments of Germany and France have strongly criticised the decision and have indicated that they would like the EU to consider changing the rules so that national champions could be created. If the EC is right in its decision on the proposed merger, then the rule changes mooted would be protectionist. As we say, this is not an issue for investors now but, longer term, needs monitoring since protectionism ultimately damages growth.

A second issue bothering investors towards the end of last year was the eurozone. The stand off between the coalition government in Italy and the EU over the 2019 budget was potentially very serious. As a heavily indebted country, Italy is very vulnerable to bad economic news and, as the third largest eurozone economy, has the potential to destabilise the euro and perhaps cause it terminal damage. In the end, a compromise was reached to leave Italy with a budget deficit of 2.04% of GDP in 2019, down from Italy's original 2.4% plan. However, reaching this target will depend upon Italy's growth rate which the Italian government now estimates at 1% for 2019, down from its April projection of 1.5% which was viewed as unrealistic, and, with the Italian economy currently facing difficulties, 1% might be a stretch. Here one should note that the latest OECD projection for 2019 shows the Italian economy contracting by 0.2%. For the moment, this has moved away from the top of investors' fears but remains a live issue. The second event was the protests by the gilets jaunes in France which forced President Macron to take measures which meant that the budget deficit was likely to be 3.4% of GDP in 2019, above the limit allowed by the EU in its rules, although nobody expects France to be punished for this breach. If fiscal discipline breaks down in the EU, that, too, poses a longer term threat to the euro but is not an issue for now.

Nearer home, the other issue, although not as important in an international context and not a major issue for international investors, except at the margin, was and remains Brexit. For us, it is not so much Brexit which is an issue, as the political fallout from it, namely the possibility of a change in government following economic policies extreme by UK standards. If followed, the danger for the UK stock market and sterling would be considerable. As of now, it is almost impossible to know how the political situation in the UK will work out but, for this reason, the UK remains high risk and this is reflected in our asset allocation, with overseas securities providing some measure of insurance against the risks in the UK. Absent the political risk, the UK would look one of the more attractive markets. So far this year, it has kept up with most other markets, probably reflecting the hope that a "no deal" Brexit will not happen. The truth is that no one knows what will happen so a cautious note is justified.

These three influences on the markets in the last quarter of 2018 were specific ones but the general one which we flagged at the beginning of last year as the main challenge to equity markets was the course of monetary policy. Since the financial crisis, asset prices have been supported by extraordinarily loose monetary policy, both in terms of interest rates and money creation through quantitative easing. It has always been highly undesirable that this extreme monetary policy should be continued indefinitely because of the economic distortions which it causes. The challenge for equity and bond markets was how they would react to tightening monetary policy. The prospect of tightening monetary policy was an influence on markets at the back end of last year but a more emollient tone from central banks has caused markets to rise so far this year.

The USA has been leading the way in tightening monetary policy with 9 rises in the federal funds target rate since its low point in 2008. However, in many other markets, equity yields stand comfortably in excess of short term interest rates and the yields of many bond maturities. In the USA, the rise in interest rates restored the normal relationship between bond and equity yields where bond yields were higher. The challenge, we thought, was for equity markets to take rising interest rates in their stride as corporate earnings were rising strongly but, above all, for a clear signalling mechanism from the Federal Reserve, as one false move could destabilise markets. With US corporate earnings rising by over 20% last year, helped by corporate tax cuts, there was a reasonable expectation that this delicate manoeuvre on interest rates could be managed but, in the last quarter of last year when the US equity market underperformed, there were signs that the rising interest rate part of the equation was becoming more dominant. In the eurozone, where monetary policy has been operating flat out to sustain some level of growth, there was tightening, if that is what it can be called when there is a nil interest rate, as the rate of quantitative easing was gradually reduced and stopped completely at the end of the year. However, maturing asset proceeds are being reinvested, thus maintaining the level of the ECB's balance sheet. The problem for the eurozone is that, for whatever reason, probably structural, it finds growth difficult and, if it has to be extreme monetary policy which is the main factor propelling any growth, then there is a problem. With the ECB in the background creating money to buy government and other bonds in the secondary market there has been support for heavily indebted governments and this is where, for example, the Italian situation, which we touched upon earlier, comes into consideration. Italy has to market itself as an attractive opportunity. However, if the budget deficit turns out to be larger than expected, funding the Italian budget deficit could be problematical. The

Italian economic figures and those of the eurozone are not encouraging at present and it will be a challenge to the single currency if there is a recession in the eurozone. It may be that the ECB has to resume quantitative easing as well as providing additional lending facilities, which it plans to do, but this is no long term solution to an area which seems to suffer from chronically low growth

A good guide to economic conditions around the world is provided by the various purchasing managers indices which are high value indicators. As is to be expected, those from the USA show the strongest results, although they have come off their highs. The latest US PMI from the manufacturing sector stands at 54.2 and 59.7 for non-manufacturing, which suggest quite good growth and are way ahead of anywhere else. For the eurozone, the latest composite index stands at 51.9, suggesting hardly any growth, with the manufacturing PMI standing at 49.3 and the services PMI at 52.8. Within the eurozone, the German composite PMI stands at 52.8, suggesting only modest growth, but the manufacturing PMI stands at 47.6, suggesting contraction in that area of the economy. The French composite PMI stands at 50.4, suggesting hardly any growth in the French economy and, most concerning of all, is Italy where the composite PMI suggested contraction, the latest index level being 49.6. Within that, manufacturing was very weak at 47.7 and services a little stronger at 50.4. Although stronger than in the three largest eurozone economies mentioned above, Spain's data has shown some deterioration. Its composite index stands at 53.5. Within that the services PMI stood at 54.5 but manufacturing was very weak at 49.9. For the UK, the latest manufacturing PMI stands at 52.0, services at 51.3 and the composite index at 51.5, again suggesting low growth. For Japan, the latest composite index stands at 50.9, with manufacturing at 48.5 and services at 51.6. For China, the latest manufacturing PMI stands at 49.2 and non-manufacturing at 54.3. The Japanese composite PMI was suggesting hardly any growth standing at 50.7 with the manufacturing PMI in negative territory at 48.9. For China, where economists and investors look at the data very carefully, the figures are not particularly healthy with the manufacturing index at 49.2, suggesting contraction as the sector is hit by the trade skirmish with the USA and the non-manufacturing PMI standing at 54.3.

In response to a weakening of economic growth internationally, monetary policy as we have mentioned, has started the year being loosened compared with the policy trajectory expected towards the end of last year. In the USA, as pointed out, the Federal Reserve has adopted a more dovish tone in response to international developments and, perhaps, the weakness of US equities in the final quarter of 2018. The ECB has adopted a softer line. It has confirmed that ECB interest rates are likely to remain unchanged at current levels throughout 2019. The ECB also stated that it would continue to reinvest in full the principal payments from maturing securities under the asset purchasing programme for an extended period of time past the date when the ECB starts raising key ECB interest rates and, for as long as is necessary, to maintain favourable liquidity conditions and an ample degree of monetary accommodation. The ECB has also decided to launch a new series of quarterly targeted longer term refinancing arrangements (TLTRO - III) starting in September 2019 and ending in March 2021, each with a maturity of two years. It did not, however, restart its quantitative easing programme which it stopped at the end of last year.

In China, where a respectable rate of economic growth remains crucial to the government's economic plans, whilst at the same time reining back the shadow banking sector, pragmatism has had to trump the latter policy, at least temporarily, as the central bank has reduced the banks' reserve ratio twice in January and the equivalent of US$116 billion of liquidity was released as a result. In early March, tax cuts were announced as well to give a further boost to the economy.

The latest OECD Interim Economic Assessment published in early March sets the scene for change in tack for monetary policy in a number of important countries and areas. There are some significant downgrades in its forecasts for economic growth in 2019. Compared with its November 2018 forecasts, the OECD now sees world growth in 2019 at 3.3% compared with its forecast of 3.5% in November and a 3.6% outcome for 2018. Amongst the G20 countries, the only two for which it has raised its forecasts for 2019 are Argentina (it still sees a contraction of 1.5% and South Africa where it now sees growth of 1.7%). Looking within its projections, the best performers amongst the developed countries are expected to be the USA (2.6% growth) and Australia (2.7% growth). But the biggest downgrades in the developed countries are seen in the euro area (1.0% growth) where Germany is now seen growing by only 0.7% and Italy is seen contracting by 0.2%.

The forecast for the UK has been reduced to 0.8%. Elsewhere, the forecast for China has been reduced to growth of 6.2% this year (lower than in recent years) and for India to 7.2%. Turkey, an important economy, has seen a sharp fall in the OECD's projection for this year. The OECD sees economic contraction of 1.8%.

The area of most concern should probably be the eurozone. That only such a modest growth level can be forecast on the back of such a huge monetary stimulus shows a major structural problem. We have often pointed out how weakly the single currency is underpinned by fundamentals and, if the OECD's forecast for Italy turns out anywhere near correct, there is going to be a significant problem. The compromise reached between Italy and the EU over this year's budget was totally unconvincing and, if the economy does contract, the budget deficit forecast will be significantly exceeded. Italy may cause the eurozone a considerable problem as the year goes on.

For investors, apart from the important USA/China trade issues, the implications to be drawn from the worsening economic outlook mainly surround the course of monetary policy. Whilst it is highly undesirable that economies, stock markets and asset prices generally should have to be supported by ultra loose monetary policy because of the distortions which build up in the system, it is likely to be a helpful background to stock markets this year. The trade off we saw last year was between rising interest rates and corporate profits; this year it is likely to be between lower than previously expected growth and easier than expected monetary policy. Central banks' signalling will remain very important but the clear slowdown in the economic growth rate makes it unlikely that central banks will risk being too aggressive in implementing monetary policy. Very loose monetary policy is therefore likely to be supportive of equity markets, assuming some kind of satisfactory resolution of the USA/China trade conflict.

For sterling based investors, the risks remain high because of the uncertain political situation in the UK. It remains essential to have a widely diversified portfolio by geography to mitigate these risks. This is apart from compelling evidence that home bias reduces returns compared with a well diversified international portfolio. Our policy therefore remains unchanged.