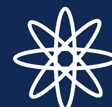

meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equity markets have continued to rise over the past 3 months although currency movements have adversely impacted upon sterling returns which have, nevertheless, still been satisfactory. Bonds have had a more difficult quarter with yields trending upwards. In the foreign exchange market, sterling has been the stand out performer with a large rise in value against a very weak US dollar. The oil price has continued to strengthen in US dollar terms.

The tables below detail relevant movements in markets :

International Equities 31.10.17 - 31.01.18

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+2.8	+1.3	+8.5	+1.5
Finland	-0.1	-0.3	+6.8	-0.1
France	+0.3	+0.1	+7.2	+0.3
Germany	+0.5	+0.3	+7.4	+0.5
Hong Kong, China	+11.1	+3.5	+10.8	+3.6
Italy	+3.9	+3.8	+11.1	+3.9
Japan	+4.3	+1.4	+8.6	+1.5
Netherlands	+0.3	+0.1	+7.2	+0.3
Spain	+0.3	+0.2	+7.3	+0.3
Switzerland	+0.8	+1.0	+8.1	+1.1
UK	+1.0	+1.0	+8.1	+1.1
USA	+10.2	+2.9	+10.2	+3.1
All World Europe ex UK	+0.8	+0.4	+7.6	+0.6
All World Asia Pacific ex Japan	+7.8	+3.5	+10.8	+3.6
All World Asia Pacific	+6.4	+2.6	+9.9	+2.8
All World Latin America	+10.4	+6.8	+14.3	+6.9
All World All Emerging Markets	+9.9	+6.1	+13.6	+6.2
All World	+6.9	+2.4	+9.6	+2.5

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : -0.3%

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

Currency	31.10.17	31.01.18
Sterling	1.37	1.49
US Dollar	2.40	2.73
Yen	0.07	0.08
Germany (Euro)	0.37	0.63

Sterling's performance during the quarter ending 31.01.18 (%)

Currency	Quarter Ending 31.01.18
US Dollar	+6.9
Canadian Dollar	+2.1
Yen	+2.8
Euro	+0.3
Swiss Franc	N/C
Australian Dollar	+1.7

Other currency movements during the quarter ending 31.01.18 (%)

Currency	Quarter Ending 31.01.18
US Dollar / Canadian Dollar	-4.5
US Dollar / Yen	-3.8
US Dollar / Euro	-6.2
Swiss Franc / Euro	+0.2
Euro / Yen	+2.5

Significant Commodities (US dollar terms) 31.10.17 - 31.01.18 (%)

Currency	Quarter Ending 31.01.18
Oil	+11.7
Gold	+5.9

MARKETS

It has been another solid quarter for international equity markets. In local currency terms, the FTSE All World Index has returned +6.9%, in sterling terms +2.4%, in US dollar terms +9.6% and in euro terms +2.5%. Looking at local currency returns first, the outstanding performer was the USA where the FTSE USA Index returned +10.2%. There were also strong performances from the FTSE All World Latin American Index (+10.4%) and the FTSE All World All Emerging Markets Index (+9.9%). There were below average performances from the FTSE UK Index (+1.0%), the FTSE All World Europe ex UK Index (+0.8%), the FTSE Australia Index (+2.8%) and the FTSE Japan Index (+4.3%). Turning to the sterling adjusted figures, the weakness of the US dollar over the quarter pulled back the return on the FTSE USA Index such that its return of +2.9% only slightly exceeded that of the FTSE All World Index in sterling terms which, as detailed above, returned +2.4%. However, the FTSE All World Latin American Index (+6.8%) and the FTSE All World All Emerging Markets Index (+6.1%) continued to show a good outperformance in sterling terms.

In the international government bond market, as represented by ten year government benchmark bonds, yields rose in all of the markets that we show in the tables at the beginning of this review. The UK gilt gross redemption yield rose by 12 basis points to 1.49%, that on the US Treasury bond by 33 basis points to 2.73%, on the German Bund by 26 basis points to 0.63% and on the Japanese Government Bond by 1 basis point to 0.08%.

In the currency markets, sterling continued to demonstrate all round strength. Against the US dollar it rose by 6.9%, against the yen by 2.8%, against the Canadian dollar by 2.1%, against the Australian dollar by 1.7% and against the euro by 0.3%. It was unchanged the Swiss Franc.

In the commodities markets, oil, as measured by Brent crude, rose by 11.7% and gold by 5.9% in US dollar terms but, of course, the US dollar was very weak over the quarter.

ECONOMICS

2018 has started well from an economic perspective with synchronised economic growth and the outlook apparently brighter than it has been for a long time. This is reflected in January 2018's World Economic Outlook Update from the IMF which, compared with its last publication in October 2017, has raised its forecast growth expectations for the world economy by 0.2% for each of 2018 and 2019, quite a large increase in a short time. The IMF now sees growth for 2018 and 2019 at 3.9% compared with 2017's estimated growth rate of 3.7%. Within that figure, there is a sharp increase in the projections for Advanced Economies by 0.3% for 2018 to 2.3% and by 0.4% for 2019 to 2.2%. Breaking down Advanced Economies further, its projected growth rate for the USA has been dramatically increased by 0.4% for 2018 to 2.7% and by 0.6% for 2019 to 2.5%. The eurozone, too, has seen a significant uplift. For both 2018 and 2019, the projection has been raised by 0.3% to 2.2% and 2.0% respectively. Within the eurozone, the largest increase in the IMF's forecast is for Germany, where the IMF has revised up last October's figures by 0.5% for both 2018 and 2019 to 2.3% and 2.0% respectively. Elsewhere in the eurozone it has become more optimistic about Italy, raising its 2018 forecast to 1.4%

and that for 2019 to 1.1%, increases of 0.3% and 0.2% respectively. For Japan, the IMF has raised sharply, by 0.5%, its forecast for 2018 to 1.2% and just shaded it higher by 0.1% for 2019 to 0.9%. For the UK, it has left its 2018 forecast of 1.5% unchanged but trimmed its forecast for 2019 by 0.1% to 1.5% also. One of the faster growing G7 economies has been Canada and the IMF has become more optimistic, raising its 2018 forecast by 0.2% to 2.3% and by 0.3% for 2019 to 2.0%. Amongst Emerging Market and Developing Economies, the IMF has left its forecasts unchanged for both years at 4.9% for 2018 and 5.0% for 2019. China's growth forecasts for 2018 and 2019 have been raised by 0.1% for both years to 6.6% and 6.4% respectively, whilst there has been no change for India at 7.4% and 7.8% respectively. It is more optimistic about Brazil, which has experienced a torrid time, and the IMF now sees growth of 1.9% for Brazil in 2018 and 2.1% in 2019, increases over its October 2017 projection of 0.4% and 0.1% respectively. The IMF has slightly raised its inflation forecasts. For Advanced Economies, it now sees consumer prices rising by 1.9% this year and 2.1% next year, increases of 0.2% and 0.1% respectively. In Emerging Market and Developing Economies, it has raised its forecasts by 0.1% and 0.2% respectively to 4.5% and 4.3%.

This all looks very encouraging, so what could go wrong? When conditions are bad, it is easy to be too pessimistic, seeing only problems on the horizon. Equally, it is important not to get carried away when everything looks much better than it has done for a long time. Because this has been called a reluctant bull market, with many doubting its validity because of all the difficult economic and political problems which the world has faced, it is difficult to feel that there has been any euphoria, although one senses that, since the US tax reforms were passed in December, there has been a step up in optimism, perhaps because of the effect on US corporate earnings.

In examining possible reasons for caution, we will look mainly at macroeconomic factors, but, in other respects, the political and economic problems have not greatly changed. North Korea remains a potentially very dangerous threat, but it is not really possible to factor in a worst case scenario of nuclear war because we cannot be sure what would be left. If anything, the situation looks slightly less charged at present but that can easily change again. All the other flashpoints remain, particularly in the Middle East, and the recent centre of attention has been Iran, with its internal demonstrations and a more aggressive approach from the USA towards the nuclear deal with Iran. Broadly speaking, there has not been any change in the international political position. It is not good but it has not got any worse. That could change if there was some sort of conflagration in the Middle East which affected oil supplies and raised the oil price sharply putting a brake on economic growth.

It is probably more sensible to concentrate on the macroeconomic picture, which may influence securities' prices more. What economists call automatic stabilisers should be used to ensure that neither booms nor recessions get out of hand. Therefore, when an economy is growing strongly, fiscal and monetary policy should be tighter to stop it overheating and causing inflation as an economy comes up against capacity limitations. On the other hand, when an economy is in recession or depressed, looser fiscal and monetary policy could help it to recover. Whereas investors, particularly in the UK, used to worry about inflation, in more recent times, the concern, although not so much in the UK this time, has been about very low inflation. At a time when many economies have been recovering, a surprising feature for many has been the failure of inflation to rise. One danger is that complacency will set in and that the view takes hold that current low inflation rates are here to stay, irrespective of the point at which an economy is standing in the economic cycle. The danger of the fiscal stimulus which is being administered in the USA is that it will provide a further boost to an economy which is performing well and lead to inflationary pressures. In other words, the automatic stabilisers will be disabled. The US economy might become seriously overheated leading to inflationary pressures building up. If that were to occur, the Federal Reserve might become more aggressive in its approach to interest rates. Already, there is some speculation that there might be four interest rate increases this year, rather than the three which most people had expected. When an economy is performing well, the opportunity should be used to prepare for the next economic downturn. This means attempting to improve the budgetary and public debt situation. Prior to the financial crisis in 2008, the UK adopted an expansionary fiscal policy at a time when the economy was performing well. When the recession came, the UK had no

cushion to withstand the deteriorating fiscal position and the UK is still trying to recover from that problem. The horizon for a balanced budget keeps getting pushed out further and public debt levels are uncomfortably high. This, as we see it, is the main danger from the US fiscal stimulus for the USA.

The USA is leading the way in tightening monetary policy, albeit from an extremely loose level. Very low levels of interest rates have helped to stimulate asset prices and, now that there is to be a fiscal stimulus, the case for tightening monetary policy becomes even stronger as an offset to some degree to the fiscal stimulus. A heady cocktail of ultra low interest rates and over accommodative fiscal policy is likely to threaten an overheated economy with sharp inflation increases. An economic stimulus at the wrong time of the economic cycle may be the biggest threat to the US stock market.

But, in pointing out possible macroeconomic disadvantages of providing an economic stimulus at this stage of the cycle, it would be churlish not to point out the positive aspect of tax cuts and investors would surely prefer tax reductions to tax increases. The theoretical underpinning to the tax cuts is that they are part of the President's supply side reforms together with deregulation. Dealing with the latter first, regulations in the USA, as elsewhere, have proliferated in recent years, often for political rather than for economic reasons. Regulations, whether justified or not, impose a cost on businesses and individuals, and the President has been strong on repealing regulations where he feels it necessary and where he is able to do so. Of course, many will quarrel with his deregulation programme, but the fact is that it will reduce costs and perhaps arouse Keynes's "animal spirits". This is the relatively cost free part of his supply side reforms. As for tax cuts, supply side proponents will argue that they will pay for themselves by stimulating further economic activity and, therefore, tax revenues. Businesses are the main beneficiary of the tax cuts with the company tax rate falling from 35% to 21%. There is a large incentive to invest now as capital expenditure for short lived investment can be written off against profits immediately. So, suppliers of relevant capital equipment will benefit from an increase in orders setting off an economic multiplier effect, companies which invest in capital equipment should enjoy a productivity boost, whilst shareholders should benefit from higher dividends which can be recycled around the US economy. On top of this, money repatriated by US companies from abroad at the favourable 15.5% tax rate could reinforce these economic drivers. Those opposed to the tax cuts may have a political agenda or they may believe that the effect will be to worsen significantly the USA's budgetary and debt levels and that this could come back to haunt the USA when economic conditions become more difficult. Only time will tell, but investors will want to look at the effects of the tax cuts and will be assimilating information from companies as they report their quarterly figures during the year. In its latest World Economic Outlook, the IMF estimates that the effect on growth will be positive through to 2020, cumulating to 1.2% through that year with a range of uncertainty around this central scenario. Thereafter, because of the temporary nature of some of its provisions, the tax policy package is projected to lower growth for a few years from 2022 onwards. The IMF went on to say that the effect of the package on output in the USA and its trading partners contributes about half of the cumulative revision to global growth over 2018-2019.

That is the fiscal side but, when one looks at inflation and projected growth in the USA and then puts out of one's mind for a moment the current level of interest rates in the USA, but instead looks at the inflation and growth rates, one would expect to be seeing short term interest rates of perhaps 4% instead of the current federal funds target range of 1.25% to 1.5%. The danger of having short term interest rates below inflation rates is that they encourage borrowing, probably pushing up asset values, leading to a bubble and its painful bursting with the resulting unpleasant fall out.

So, whilst, in principle, the US tax cuts are welcome and represent a break with the recent past, one must be aware that they may have come at the wrong time in the economic cycle. Wall Street, however, at least so far, has welcomed the package, pushing US share prices to new all time highs on most days as companies detail the benefits to them in most cases. Although the tax cut will affect different companies in different ways, it is estimated that they will add at least 6% to US companies' earnings per share. Other analysts put the figure much higher. Whatever the level of increase, it does justify a higher level of US equity prices than would otherwise have been the case, although some would argue that they are

starting from too high a base. We would not agree with the latter proposition, although the recent rates of increase of US share prices are not sustainable and periodic setbacks are inevitable.

Although at a different stage of the economic cycle, being somewhat behind the USA, some of the same monetary policy issues still apply to the eurozone. As we can see from the IMF's forecasts, growth is expected (by the eurozone's standards) to be quite robust in 2018 and 2019 and yet here we have a 0% repo rate and a negative deposit rate. Whilst policy makers would like to regard the eurozone as an homogenous area for the appropriateness of a particular interest rate, it is, of course, nothing of the sort, and herein lies a potential problem with some similarities to the US situation mentioned above. The economy of Germany is performing strongly, with good growth and low unemployment, the latest level being 3.6% compared with the eurozone average of 8.7%. The latest consumer price index shows a year on year increase of 1.7%. The German government ten year bond yield is approximately 0.63%. If Germany still had its independent currency, it is safe to say that it would be starting at a higher level relative to other eurozone countries if they also had their own currency, the effect of which, other things being equal, would be to have a lower inflation level and a much lower current account surplus, currently standing at around 7.9% of GDP. The extremely competitive level of the euro so far as Germany is concerned has led to its economic boom, but current interest rates levels set by the ECB, which are completely inappropriate for Germany, risk seriously overheating the economy and lead to much higher inflation. With the German government unable to count on its own central bank to set an appropriate interest rate level because it has ceded authority to the ECB, the other economic tool to cool down the economy and attempt to ward off inflationary pressures would be fiscal policy. But this would be almost impossible at the moment. As this is written, it is still uncertain whether SPD members will vote to support the party joining a grand coalition with the CDU/CSU, but, in any case, with the two major political parties (counting the CDU and CSU as one for these purposes) seriously weakened by the last federal election result, it would not be easy to raise taxes or cut public expenditure. It would seem all the more perverse to many German voters were fiscal policy to be tightened, given that Germany is running a significant budget surplus. So, the warning signs are there in a negative real interest rate, low unemployment and a large current account surplus, suggesting a significantly undervalued currency. With a monetary stimulus also still being employed by the ECB, albeit with a reduced amount of quantitative easing, monetary policy is hugely inappropriate for Germany. After years of wage restraint, the German trade unions, particularly the powerful engineering union, IG Metall, are pushing for substantial pay increases. Even though the ECB's monetary policy is more suitable for some of the weaker eurozone economies rather than for Germany, a position can be envisaged where the ECB has to take note of Germany's economic data and start to tighten monetary policy. This can be expected to have negative effects on weaker members of the eurozone. In this context, very low eurozone interest rates have helped to shield highly indebted countries from the dangers posed by very high debt levels, but a rise in debt servicing costs will challenge highly indebted countries and cause some of the eurozone's earlier problems to reappear. Whilst the overall level of eurozone unemployment suggests there is still under used capacity in many eurozone countries, that is not the case in Germany. This is a good example of where a "one size fits all" monetary policy in the currency union is inappropriate. The normal checks and balances of a floating rate exchange rate regime are absent from within the eurozone. So, whilst eurozone conditions look more encouraging at the moment, investors should be aware of these potential problems.

Indeed, this raises the much wider question of whether the world economy can only grow at its current projected rate because of the sheer weight of the monetary easing that has occurred since the financial crisis. Not only have many interest rates been reduced to very low or negative levels but central banks' balance sheets, as a result of quantitative easing, have ballooned to unimaginable levels. The Federal Reserve's balance sheet stands at around US$4.5 trillion, that of the ECB at around US$5.3 trillion and that of the Bank of Japan at around US$4.6 trillion. Had there been more confidence, the newly created money would have circulated around the world economy more quickly and growth and inflation would have increased more rapidly, but the question which has to be asked is if it took this amount of monetary stimulus to get to where we are today, can the world economy stand on its feet when the monetary stimulus is withdrawn? One thing which would be helpful is if securities' markets remained

calm when this is happening. A sharp fall in the stock market would dent confidence and discourage businesses from investing, something which is essential to improve the long term potential growth rate of the world economy and increase productivity. To increase real wages, productivity must increase over any extended period and poor productivity growth has been a disappointing feature of the world economy in recent years helping to account for the squeeze on real incomes. There has been a prolonged period of upward movement in securities' prices, which makes it more important than ever that there is no violent stock market reaction to tighter monetary policy which would affect businesses' and individuals' investment decisions. Essentially, that means no shocks for investors in terms of their expectations about monetary tightening, putting a premium on careful signalling by the central banks. It is fairly obvious that the central banks are well aware of this. For example, the Federal Reserve's way of reducing its balance sheet is to increase the amount of its maturing asset holdings which it is not going to reinvest in the market, effectively increasing the supply of bonds to be absorbed by the market. That seems less aggressive than entering the market as a big seller of fixed interest securities. At the same time, the Federal Reserve has given a pretty clear signal of its intentions to raise interest rates further over the next two years. In the absence of any unexpected developments, the path of monetary policy looks fairly clear in the USA, the main question being whether the new fiscal stimulus will encourage the Federal Reserve to be more aggressive in its interest rate intentions, as we discussed earlier.

The ECB is behind the USA in terms of monetary policy moves and does not seem inclined to move on interest rates, rather it is relying on a reduction in the rate of quantitative easing to start its tightening, although that is a relative position since its balance sheet will be growing, but at a lesser pace than before. Since the start of the year, it has halved the rate of purchases of assets to €30 billion a month until September and we will see what happens thereafter. So, again, the supply of bonds to the market will be greater than it would otherwise have been compared to last year.

Apart from the ECB, the other major country which is still conducting quantitative easing is Japan. Although there have been some veiled hints that the Bank of Japan may be modifying its aggressive policy of purchases at the long end of the market since it reduced its purchases in January, it is conjecture at the moment as to whether this represents a policy change. It has been an aggressive buyer of fixed interest securities and equities through exchange traded funds.

An important reason for wanting to see the normalisation of interest rates at the earliest possible point is to give the ability to reduce them again to stave off an economic recession. At present, that ability has been exhausted by the current level of interest rates. But it is the trade off between economic growth and interest rate levels which will be the prime concern of equity investors. The early stages of the path of interest rate increases resulting from an improvement in economic growth rates should not be problematical for shares because corporate profits should be rising at a good rate and, with them, dividends. If, however, interest rate increases lag behind the curve because central banks have not been sufficiently proactive and inflation takes off, that will be bad for equity markets. In a nutshell, this is what equity investors have to look out for in 2018.

Although equities and fixed interest securities have performed well, the distortion between the valuations of the two asset classes remains. We have maintained for a long time that fixed interest securities are seriously overvalued and there is no doubt that the very low level of interest rates and fixed interest yields has raised the relative valuation of equities. In many of the leading stock markets, although no longer the USA, equity yields are higher than their respective governments' ten year bond yields which has led to some income investors seeking their yield through equities. Whilst inflation levels may, but not necessarily will, settle at a lower level than in previous decades, taking ten year government bond yields again, we can see that there are positive real yields in Australia, Italy, the USA and Canada and many of the Asian economies, whilst in much of the eurozone, Japan and the UK, real yields are negative, held down by monetary policy. This is not a healthy state of affairs. Negative real interest rates can cause asset bubbles, either because they encourage too much borrowing for speculative purposes, or because they drive investors into risky assets which offer a real yield.

Investors are becoming increasingly nervous of a bond crash and it is as if they know it is going to happen but are concerned if they bail out too early. When the bubble does burst, it is likely to be a painful process. The current level of bond yields, other than at the short dated end, does not offer anywhere near sufficient returns for the risks involved.

Therefore, absent any event which we cannot currently foresee, we think that the big challenge for the equity market in 2018 is to accommodate a tightening in monetary policy. For this to happen, the forecasts for economic growth, corporate earnings and dividends have to be realised and there must be no event which causes the authorities to tighten monetary policy more quickly than the market is expecting. Such an event could be inflation rising more quickly than currently anticipated or economic growth surpassing expectations, leading to overheating concerns.

We now turn to look briefly at major areas of the world economy starting with the USA. The important recent development has been the passing of the tax cuts which we have talked about at length earlier on in this review. Wall Street has reacted well to the news of the passage of the Act, reaching new highs most days. Investors had reduced their expectations of tax reform as the President struggled to obtain agreement in Congress so, when agreement was finally reached without any support from the Democrats at the end of 2017, the market had not fully discounted it and prices rose. For obvious reasons, US bonds have not reacted so well because of fears about an increasing budget deficit and inflation and yields have risen sharply. One other trend has developed which is accelerating US dollar weakness. We noted in our year end review that sterling had appreciated by 9.6% against the US dollar and this trend has accelerated so far in 2018 and not only against sterling.

Why might the US dollar have been so weak? This was not generally expected a year ago so has come as a surprise to many. From the President's point of view, it has advantages. It makes US companies more competitive and reduces the pressure on him to call for protectionist measures against imports (though note the solar panels and washing machine tariffs recently announced) or to press for some countries to be designated as currency manipulators. A weaker dollar should help manufacturing and those who worked in this sector gave significant support to the President in the Presidential election, helping him to win some key states. For businesses with significant overseas interests, either through exports or through foreign subsidiaries, the weaker dollar will boost profits and encourage firms to expand the numbers of those whom they employ, again a boon for the President. However, the fact that the President might welcome a weaker dollar does not explain why it should have been weak in 2017 and continues to be so in 2018. After all, there were, and still are, reasons why one might expect the currency to be strong. The economy is performing quite well and is expected to do better in 2018. This could attract more investors into the USA. The Federal Reserve is leading the way in raising interest rates and the gap between US interest rates and those of other major countries and regions will almost certainly widen in 2018. One might expect this widening gap to encourage flows into the US dollar in search of scarce income. On the negative side, the USA has a significant current account deficit, around 2.4% of GDP, not as high as the UK's 4.5% but comparing unfavourably with the eurozone's 3.2% surplus and Japan's 4.0% surplus. Foreign investors hold substantial amounts of US government debt and the deterioration in the US budget balance, which will necessitate more government debt issuance, could lead to foreign selling on fears that interest rates and bond yields will rise. Because the Federal Reserve plans to reinvest a progressively smaller percentage of its maturing bond proceeds, the supply position will worsen. Bellicose protectionist noises from the President, if translated into significant action, could lead to retaliation, notably by China, a major holder of US government debt (US$1.18 trillion at the end of November). Whatever the cause of the US dollar's weakness, US companies' revenue and earnings are likely to see a considerable benefit and, as the USA is a relatively closed economy (imports are only about 15½% of GDP), the effects on inflation are likely to be less than in a relatively open economy like that of the UK. We think that the positives for US equities are strong economic growth and a competitive dollar, which means higher corporate earnings and dividends. Factor in also the repatriation of cash from overseas at the 15.5% rate, some of which will go into higher dividends and more share buy backs and, hopefully, a lot into business investment, and there remains a positive case for US equities. The higher level of earnings

per share as a result of the corporate tax cuts helps to validate the rise in US share prices post the passage of the US tax cuts. The negative for the market is the probability of rising bond yields which will challenge the relative attraction of equities. At present, we consider that the positives outweigh the negatives, given that one, but not the only, reason for rising interest rates is the strength of the US economy which investors can take in their stride for the moment. The danger would be if interest rate increases were behind the curve, meaning that they were not responding fast enough to increases in inflation. If this were to be the case and the Federal Reserve had to raise interest rates significantly to try to retrieve the situation, that would be negative for US equities. That is not the situation now but the rate of tightening of monetary policy needs to be watched for its relationship to the inflation outlook.

With respect to the eurozone, we have discussed some of the issues with regard to monetary policy earlier. As the ECB reduces the rate of growth of its balance sheet, it will increase the pressure on heavily indebted economies because a large buyer of their debt in the secondary market, the ECB, is not purchasing as many bonds. There is no doubt that the yield compression, which quantitative easing has caused, has hidden relative credit issues which could come to the fore as these countries have to sell their bonds to finance their deficit or refinance maturing debt. Whilst the hiatus in Germany caused by the collapse of coalition talks and now the wait to see if the SPD members support a new grand coalition with the CDU/CSU has captured a lot of attention, the more important issue is the forthcoming Italian election in March where a majority of the parties have a highly sceptical view of the EU with mandated budget constraints a particular issue. With Italy being the third largest eurozone economy, and a heavily indebted one at that, with outstanding public debt at about 133% of GDP, a challenge to the EU's budget deficit rules will pose a significant problem for the EU and confidence in the euro if the rules are flouted. It is important for investors to bear in mind that the present good performance of the eurozone economy is not based on solid foundations. The ECB President, Mr. Draghi, has been pressing countries to use the breathing space afforded by the improved economic outlook to implement structural reforms to improve the area's longer term growth prospects. In France, there have certainly been some reforms to the employment market and cuts in taxation which were badly needed if France was to appear as a more business friendly country but there is still a long way to go. Unfortunately, the general movement in the EU is towards more regulation and protectionism which will not help to improve its long term performance potential. Whilst it is pleasing that the eurozone is performing much better, investors need to be aware that the next recession could cause problems for the common currency. As always, it is important to distinguish between the sovereign and the companies in the relevant country or region. We remain of the view that eurozone shares offer good value, as well as do those of Switzerland where the weakness of the Swiss Franc against the euro has been helpful against a background of Swiss companies having had to make some competitive adjustments to their costs when the Swiss Franc demonstrated its extreme strength against the euro.

In reviewing different markets, Japan seems to attract relatively little comment despite its size. In some ways, it is insulated from other countries because the vast majority of its vast public debt is held internally. We touched earlier upon its enormous quantitative easing programme. It has pulled out every monetary and fiscal stop to try to restore inflation to the economy and thereby to encourage spending and more economic activity. In this respect, consumer prices are positive at 0.5% year on year but well below the 2% target. Unemployment is very low at 2.7% and Japanese companies are finding it hard to recruit staff. Immigration is very low so this cannot help the problem. One might expect this to be causing wages to rise, but Japanese employees are reluctant to push for significantly higher wages. Structural reform, the third of Prime Minister Abe's arrows after fiscal and monetary ones, has lagged, but it is necessary that reforms do take place to make the economy more flexible against a background of very bad demographics. If not addressed, this will have a serious negative effect on the country's long term growth prospects. For the moment, investors can reflect on an economy which is performing quite well, albeit under a heavy stimulus, and with a Prime Minister which secured a strong mandate in last year's election. The Japanese stock market performed well in 2017, albeit with the return for foreign investors lessened by the yen's weakness, and it remains an attractive home for international equity money given the economic and corporate outlook.

In China, it is perhaps political developments that have been to the fore. President Xi has accumulated extraordinary power around him and his thoughts have been embodied in the constitution, a sign of his immense authority. From an economic perspective, it means that plans can be activated quickly, not only in terms of developing infrastructure further but in terms of controlling lending qualitatively and dealing with potential trouble spots. When China's foreign exchange reserves started to dwindle, albeit to around a level of around US$3 trillion, the authorities were able to clamp down on the currency leakage and also to introduce qualitative controls on overseas investment, with certain sectors favoured and others not. Party influence on SOEs (state owned enterprises) has been strengthened, whereas foreign investors had hoped they would become more market orientated. There are also major concerns about the high level of debt in the economy, an issue the authorities are addressing. All the time, in the background, is the fear of a trade war developing with the USA, given President Trump's bellicose rhetoric. On this score, although we noted the USA's imposition of tariffs on solar panels and washing machines, the situation has been contained. As China's "A" shares enter, in a modest way initially, the MSCI's Emerging Markets Index this year, interest is bound to rise. Despite the political and economic issues just mentioned, the Chinese economy appears to be performing reasonably well and exposure through countries and companies exposed to China remains a positive investment prospect as the country's economic power becomes ever stronger.

Emerging Markets performed very well in 2017 and the outlook seems set fair at the moment and we retain exposure to this sector. The concern a year ago was that the US dollar would increase in value as interest rates rose, or that it would introduce significant protectionist measures and that money would flow out of emerging markets causing a liquidity shortage and rising interest rates. As we know, this did not happen and emerging market currencies, as a whole, rose against the US dollar with rising commodity prices supporting many emerging market economies. Emerging market economies have generally improved their financial strength and, for the moment, the threat of a liquidity squeeze caused by funds flowing into the US dollar has receded. As the IMF forecasts suggest, growth is likely to remain solid in this area. A strengthening world economy should be supportive to commodity prices and, at this early stage of the year, there is no reason to believe that they will underperform developed markets. The issues to watch will be a sharp reversal in the US dollar's fortunes and an outbreak of protectionism and an ensuing trade war.

Finally, we come to the UK. It is important to say that the worst projections of the pessimists over Brexit have not come to pass and that the economy is performing reasonably well, not quite at the rate expected in some other major economies, but still satisfactorily, as the IMF forecasts show. Fourth quarter growth for 2017 of 0.5%, just announced, beat expectations and the 1.8% year on year growth rate should be put in the context of an economy which outperformed most G7 economies in recent years. It was inevitable post the EU referendum vote in 2016 that there would be a lot of extraneous "noise" as the parties involved on both sides of the argument tried to use misinformation and disinformation to gain a tactical or negotiating advantage. This is set to go on until the UK leaves the EU in 2019 and the argument will, no doubt, continue long afterwards. Whilst there are economic issues for the UK, as there are for all countries, such as the squeeze on real incomes which is hitting many people hard and the budget and current account deficits, there are also positive features like record numbers in employment and a satisfactory growth rate. As this is written, sterling has been performing very strongly and, against a weak dollar, is close to where it was before the results of the EU referendum started to come in. It is difficult to rationalise the strength of sterling other than to say that it is a counterpart of a weak US dollar. It may have fallen too far post the Brexit vote, given that we now know the economy did not perform badly, as some said it would. On other possible drivers of a currency's movement, such as current account figures and relative interest rates, there is nothing to suggest that the pound should be strong. It is a mystery. This is particularly so in what we regard as the biggest risk to the UK, more so than Brexit, which is the political uncertainty. The government is weak and, although the Fixed Term Parliament Act makes calling an election before June 2022 difficult, it can be done if the government loses a vote of no confidence or two thirds of MPs vote to call an election, as happened last year. The policies put forward by the Opposition are more extreme than anything proposed before and would be likely to affect severely the pound and

the stock market. Politics can be as important as economics in markets and our view is that sterling based investors should construct their portfolios with this political risk in mind. For this reason, although we always do this on diversification grounds, our portfolios have a heavy overseas bias. Apart from anything else, this is an insurance policy against political problems boiling over in the UK. The potential risks of an overly centric UK portfolio are considerable. This is unfortunate because, absent the raised political risks, the UK market could look one of the more attractive ones. Within even a modest UK weighting, emphasis should also be on overseas earners. At the moment, we consider the UK political risk to be the most important investment factor to consider for sterling based investors.

Meridian Asset Management (C.I.) Limited is regulated by the Jersey Financial Services Commission, under the Financial Services (Jersey) Law 1998, to carry on investment business. "Meridian" refers to Meridian Asset Management (C.I.) Limited. This document is provided for interest only. Any opinion expressed in this document is a matter of judgement at the time of writing and may be subject to change without notice. No representation or warranty, express or implied is made nor responsibility of any kind accepted as to the accuracy, completeness or correctness of the information stated herein or that material facts have been omitted. The information contained in this document is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product or service by Meridian. Various products or services referred to in this document are subject to legal and regulatory requirements in applicable jurisdictions. They may not be available in all jurisdictions. Meridian makes no representations about the suitability of the information published in this document for any purpose. It does not constitute investment advice. No information contained or referred to in this document should be construed as such. A professional adviser should be consulted with respect to your particular situation. The value of investments and the income derived from them may fluctuate and you may not receive back the amount originally invested. Past performance is no guarantee of future performance. Currency movements may also affect the value of investments. The investments and services referred to in this document may not be suitable for all investors.

© Meridian JANUARY 2018