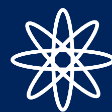
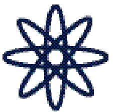


meridian

ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

Markets have been steady over the last quarter despite a bad patch in November. The indices have made modest progress and high quality government bond yields have fallen even further. In the currency markets, the feature has been the weakness of the euro and the Swiss Franc. In commodities, oil and gold have been little changed.

The tables below detail relevant movements in markets:

International Equities 31.10.11 - 31.01.12

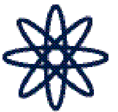
Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-0.3	+2.2	-0.1	+6.4
Finland	-1.4	-5.4	-7.5	-1.4
France	+2.6	-1.6	-3.7	+2.6
Germany	+5.4	+1.2	-1.1	+5.4
Hong Kong, China	+1.7	+4.1	+1.8	+8.5
Italy	+0.6	-3.4	-5.6	+0.6
Japan	-1.5	+3.1	+0.8	+7.4
Netherlands	+3.7	-0.5	-2.7	+3.7
Spain	-2.8	-6.7	-8.7	-2.8
Switzerland	+4.0	+0.7	-1.5	+4.9
UK	+3.1	+3.1	+0.8	+7.4
USA	+5.4	+7.8	+5.4	+12.3
Europe ex UK	+3.3	-0.5	-2.7	+3.7
Asia Pacific ex Japan	+1.4	+3.7	+1.4	+8.1
Asia Pacific	+0.2	+3.4	+1.1	+7.8
Latin America	+6.7	+7.2	+4.8	+11.7
All World All Emerging	+3.8	+5.6	+3.3	+10.0
The World	+3.8	+4.9	+2.5	+9.3

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +4.3%

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

Currency	31.10.11	31.01.12
Sterling	2.44	1.97
US Dollar	2.13	1.80
Yen	1.05	0.97
Germany (Euro)	2.00	1.79



Sterling's performance during the quarter ending 31.01.12 (%)

Currency	Quarter Ending 31.01.12
US Dollar	-2.4
Canadian Dollar	-1.5
Yen	-4.4
Euro	+4.2
Swiss Franc	+3.2
Australian dollar	-2.4

Other currency movements during the quarter ending 31.01.12 (%)

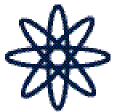
Currency	Quarter Ending 31.01.12
US Dollar/Canadian Dollar	+0.9
US Dollar/Yen	-2.1
US Dollar/Euro	+6.7
Swiss Franc/Euro	+1.0
Euro/Yen	-8.3

Significant Commodities (US dollar terms) 31.10.11 - 31.01.12 (%)

Currency	Quarter Ending 31.01.12
Oil	+1.3
Gold	-0.6

Markets

International equity markets have experienced a mildly positive quarter with the return on the FTSE World Index at 3.8% in local currency terms, 4.9% in sterling terms, 2.5% in US dollar terms and 9.3% in euro terms. Looking at local currency returns first, we note that, of the major markets, the USA performed best with the FTSE USA Index returning 5.4% in local currency terms. Elsewhere, the FTSE Europe ex UK Index and the FTSE UK index moved closely together with respective returns of 3.3% and 3.1%. The FTSE Japanese Index was the worst performer, returning -1.5% in local currency terms. Latin America bounced back after a period of underperformance with the FTSE Latin American Index returning 6.7%, whilst the FTSE All World All Emerging Markets Index returned 3.8%. The FTSE Asia Pacific ex Japan Index underperformed, returning 1.4%. However, currency movements changed the position. The strength of the US dollar meant that the return on the FTSE USA Index in sterling terms rose to 7.8%. The strength of the yen meant that the FTSE Japanese Index moved into positive territory in sterling terms, returning 3.1%. The strength of the Australian dollar meant that a negative return of 0.3% in local currency terms in the FTSE Australia Index turned into a positive 2.2% return in the sterling adjusted FTSE Australia Index. Latin America, Emerging Markets and Asia Pacific ex Japan also saw an uplift in sterling terms with respective returns in their FTSE indices of 7.2%, 5.6% and 3.7%. Moving the other way was the FTSE Europe ex UK index where currency weakness against sterling caused the sterling adjusted index to return -0.5%.



Continued extraordinary conditions in the international bond markets pushed the yield down on sovereign bonds, which are considered safe, to scarcely believable levels. Taking ten year government bonds as the benchmark, the yield on UK government bonds fell by 47 basis points to 1.97%, on US government bonds by 33 basis points to 1.80%, on Japanese government bonds by 8 basis points to 0.97% and on German government euro denominated bonds by 21 basis points to 1.79%, the latter contrasting with the performance of the weaker eurozone sovereign credits.

Economics

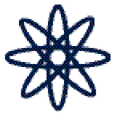
The quarter continues to be dominated by the eurozone's sovereign debt crisis and it is almost certain that this will be the theme throughout 2012. It is not an issue which is going to go away. It is difficult to overemphasise the seriousness of the current economic crisis, yet markets overall have trended higher over the quarter notwithstanding a bad spell in November.

Before we discuss the economic background and, in particular, the eurozone's crisis, it is worth reflecting on why, with such an ugly economic background, equity markets can seem to shrug off the crisis, albeit that we are talking about a fairly short time period. Does it not seem counterintuitive that share prices have risen in such circumstances? Partly, it depends upon where one starts from. If shares are exceptionally cheap on normal valuation methods then valuation levels might provide a base for improvement if investors weigh off the risk (from economic conditions)/reward (exceptionally cheap valuations) ratio. Secondly, markets look ahead and investors may anticipate improved economic conditions which may benefit companies. Thirdly, they may take a view on which assets are likely to benefit from the economic and financial policies being followed even in very difficult economic circumstances such as are being faced at present.

At present, there is something in the first possibility. Shares do not look expensive. Typical European stocks, including the UK, are trading on prospective price/earnings ratios of around 10 and 13.0 for the S & P 500 in the USA. These are not high historically. Similarly, and especially given low interest rates, dividend yields are appealing. In much of Europe, including the UK, prospective dividend yields are in the 4% to 5% region whilst, in the USA, a traditionally lower yielding market, the prospective dividend yield on the S & P 500 index is about 2.2%. One might think this is not an attractive dividend yield, but when one sees the gross redemption yield on the ten year Treasury bond at 1.93%, and with dividends having the potential to grow, one can see the relative attraction.

We would not, at this stage, give much credence to the second possibility, the attraction of improving economic conditions on the horizon. In the UK and Europe, investors tend to be conditioned by the very poor economic outlook but, elsewhere, the prospects are better. Here we are talking about Asia, Australasia, parts of Latin America, some emerging markets and, to some extent, the USA, which, although beset by many economic problems, has better growth prospects than Europe. Nevertheless, whilst investors can acknowledge that the picture is not wholly gloomy, the recent rise in international equity markets is unlikely to have been caused by the promise of better economic conditions.

The third possibility is, to us, the most compelling. In the major industrialised countries or regions, governments and central banks are having to take the most extreme measures to stabilise their economies. In the UK and, increasingly, in the eurozone, very tough fiscal measures are being taken to address the budgetary and debt problems. Elsewhere, in an attempt to stimulate economies or avoid recession and depression, extreme monetary measures have been taken in the form of very low interest rates and/or quantitative easing. It is the monetary measures which we believe are responsible for the resilience of equity markets and will give them support for the foreseeable future. Even if the growth outlook is poor, which it is in many of the affected countries, the strength of non financial corporate balance sheets means that the dividend experience, which was positive in 2011, should also provide support to shares in 2012. With short term interest rates almost certainly going to remain at extremely low levels for the foreseeable future and, with ten year government bond yields in the most



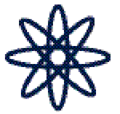
favoured countries at extraordinarily low levels, as shown by our table at the beginning of this review, dividend yields become very attractive. The search for income is a very real one, so, if dividends are sustainable, as we believe they are in the majority of cases, and with the possibility of some dividend growth even in these straitened times, the attractions of shares have increased. So, with the traditional income producing assets, cash and bonds, (all along we are only talking about high quality issues) not going to meet income requirements, shares, will, in our view, benefit by default. Low interest rates are one aspect of monetary policy which is helpful to shares and the second is the effect which money printing in the form of quantitative easing is likely to have on asset prices. Increased amounts of money chasing a finite amount of assets are likely to raise asset prices, something which happened in 2009 and, when the money parked with banks begins to find its way round the economy, asset prices, including, importantly, shares, are likely to rise further. When stated like this, printing money seems a very easy way to address the issue of low confidence. Far from it. Quantitative easing, where carried out, risks inflation. At the moment, consumers and businesses have lacked the confidence to borrow and spend but, when they do, and monetary growth rises rapidly, inflation cannot be far off. If inflation did not get out of hand then shares should be well placed to benefit, at least for those companies with some pricing power. In the circumstances of rising inflation, good quality government bonds, already in negative real yield territory would look even more expensive, enhancing the relative attraction of equities.

So, in seeking to explain what has happened to shares in the latest quarter, we think the third reason is the most compelling, subject to reason one, valuations, being reasonable, which we believe they are. It is as if the stock market has accepted that parts of the world are in a dreadful economic state but that there are enough technical reasons, as described above, to support equity prices. Their resilience has been impressive and it has been noticeable that only when the news becomes even worse have equities fallen. When the news has stabilised at what we might call the lower level, shares appear to move ahead. We have tried to explain above what we think are the reasons for the counterintuitive movement in equity markets over the last quarter.

In terms of sentiment, what we think has been very helpful in the short term, although it does nothing to solve the eurozone's fundamental problems, has been the provision by the ECB of ample liquidity for the banking sector, including three year money, the LTRO (long term refinancing operation) amounting to €489.191 billion and attracting 523 bidders. The ECB's actions have been constructive in a wholesale market which had seized up, with banks fearful of lending to each other. This has been what we might call a "negative positive" for markets. The absence, for the moment, of a bank failing for lack of funding is seen as a positive in the market.

In the same way that investors should not become too influenced by falling stock markets, so the reverse is true. One must try to stay with the fundamentals in the case of share valuations and monetary policy, as described above. So, the recent run up in share prices should not lead to any complacency about the major issue of the day, the eurozone's debt position and threats to the euro.

Nothing which has happened recently has changed our view that the eurozone will fragment, totally or partially. There is no political leadership and the decision making is redolent of management by a large committee where no one can agree. Disturbingly, no major eurozone politician has admitted, what most independent observers understand, that the currency has fatal flaws, notably the "one size fits all" monetary policy and the absence of a transfer union. As, unfortunately, is nearly always the case, politicians look no further than the next election and how they can boost their chances of election or reelection, as the case may be. The case of the finance industry is a case in point. There is justifiable anger at what happened in some banks and the level of bonuses awarded which, in many cases, were totally disproportionate but, in milking popular discontent and grandstanding on the subject, politicians, in their search for populist policies, are going dangerously far. Their tactics are partly diversionary to try to deflect blame for the present crisis from their own failings, namely promoting the single currency despite all the warnings they received about its fundamental flaws and, secondly, by overspending and failing to control their budgets and level of public debt, this outside any support for the banking sector. The Stability and Growth Pact,

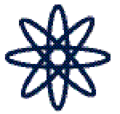


which was meant to provide the financial discipline and underpinning for the euro, was regularly flouted when it did not suit. France and Germany were guilty at an early stage, so it was no wonder that others followed. For this reason, it is impossible to give any credence to the latest ideas to enforce budgetary discipline through a treaty. The ECB has already been airing its doubts about the watering down of the disciplines and, when faced with elections and having to take unpopular measures to stabilise finances, governments, as was shown with the flouting of the Stability and Growth Pact, look to their election prospects first. Investors would be very unwise to invest in high yielding eurozone government debt on the basis that enforceable policies to deal with deficits will be successful. If they had taken comfort from the disciplines of the Stability and Growth Pact to invest in some economic countries' sovereign debt, they would be nursing some serious losses, some of which will be permanent.

Germany has been under enormous pressure from other eurozone members and non eurozone members to do more to reduce the eurozone's problems. The thinking behind this is that, overall, the eurozone is not far from current account balance but, within the eurozone, some countries, like Germany, have large surpluses and others, like those in trouble, are running, in some cases, significant deficits. The action which many are pressing on Germany is for it to reflate its economy in order to reduce its current account surplus and, as a result, reduce the current account deficits elsewhere. If Germany's inflation increased in relative terms, it would help to stabilise or reduce the loss of competitiveness, which other eurozone members have experienced since the start of the euro. All this seems rather hard on Germany. It is true that Germany has up to now received a big benefit in that the euro has been a weaker currency than the Deutschmark would have been if it had continued in existence. Germany's exports have been more competitive than they would otherwise have been and this has helped to drive the economy forward. But Germany, although it originally ignored the Stability and Growth Pact, has taken measures to restrain internal costs and remain competitive against other eurozone members. In countries like Germany, the Netherlands and Finland, all AAA rated countries, there is increasing resentment at the costs of bailing out struggling eurozone countries and this is reflected in the stand which Germany is taking to try to ensure that, if it does extend its help in the bailouts and future bailouts, it has cast iron guarantees about the path the affected countries take to improve their public finances. In practice, whatever guarantees are given, they are not likely to be worth very much. The further austerity measures which these countries take, either in the form of tax rises, public spending cuts or both, will have a depressing effect on the economies in question. This will have a negative effect on public finances and so the situation will worsen. At the end of the day, the question is how much Germany and the other AAA rated countries want the euro to continue. That might seem a silly question because surely everyone knows that the euro is sacrosanct? But is it? Opposition within Germany to the establishment of the euro was ignored but it does not mean that opinion cannot change. If Germany and other stronger members of the eurozone have to make regular fiscal transfers, it is not difficult to imagine a generation of politicians coming to power who feed off popular discontent at these transfers and who question the value of the currency union.

There is also the political angle, which is becoming more pressing. As the eurozone's leaders become increasingly desperate to strike a deal so that Greece can receive the next bail out, so the plans being mooted become further removed from reality. One was an EU plan to take control of the Greek budget to enforce any agreement. If this was true, it shows how removed from reality those proposing this plan were. Trying to overrule the sovereignty of a country or its parliament reduces the legitimacy of the EU and would, if enacted, lead to major social unrest, which would ultimately make the plan unworkable. As this is written, the EU seems to be pulling back from this position.

A further economic issue arising from the Greek bail out negotiations is the private sector "haircut" on Greek sovereign debt. The figures keep rising all the time and the latest indication is that it will be around 70%. If the IMF and ECB have preferred creditor status, it will be difficult to persuade the private sector to buy the sovereign of countries which are viewed as suspect as far as their willingness to repay debt is concerned. As currently established, we regard the euro a problem without a solution.

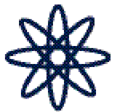


What are investors to make of this? The upward trend of markets in January suggests that investors are becoming more relaxed about the situation. In our view, the situation has not improved in the sense that the fundamental flaws in the currency union remain. What has helped has been the provision of ample liquidity by the ECB which has soothed investors' fears about some of the eurozone's banks, a situation we touched upon earlier. The removal or a postponement of a worry can act as a spur to markets. But the provision of liquidity should not be seen as a basis for increased bank lending and an economic recovery on the back of it. Banks need to build up their capital buffers and one way of doing this is through deleveraging, either by selling off assets or reining in lending. It is very unhelpful that the toxic political atmosphere stirred up by many politicians towards the banks could end up being self defeating. One does not have to be a supporter of the banking industry to understand that the revenge sought by politicians in their attempts to court popularity could be self defeating. In France, Mr Hollande has proposed an additional tax on banks. That might seem good politics but it is poor economics. It will slow down the build up of the banks' capital cushions and restrain the growth in lending. With politicians hitting out in all directions, the danger of an economic accident happening increases. For the moment, equity investors can take comfort from the actions of the ECB and a bad situation has not got worse, but one must watch out for unwise moves by politicians.

If all this sounds wearingly familiar, it is. It has been the story for many months, with crisis meeting after crisis meeting ending up with grand statements which defy reality at the time and, with the benefit of hindsight and further crises, look even more hollow. The new normal is regular crisis meetings so the news has less shock value even as it becomes more serious. Standard & Poors reduces France's long term credit rating to AA+ and the rating agencies get a blast. We cannot see how Greece can remain in the euro and now the finger is pointing towards Portugal where ten year government bond yields of 13.7% say that Portugal may not be able to pay off all of its debts. Once this trend spreads, the next most vulnerable in line is Italy being the biggest threat to the eurozone. With public debt at over 120% of GDP and ten year bond yields of around 6% (they have been over 7%), a tense situation is developing. Resistance to the necessary structural changes in countries like Greece, Portugal and Italy, where supply side reforms necessary to raise the countries' long term growth potential have been opposed, is strong. In Greece, where supply side reforms were part of the original bail out agreement, progress has been negligible. The government does not have the will to make them happen and confront the vested interests which oppose reform. The big test will be Italy where part of the proposed reforms to liberalise entry into the professions and services was met with strikes and blockades. Because Mr Monti is not a politician he can, therefore, try to progress these reforms without having to worry about the electoral consequences. He is probably Italy's best chance of breaking with the past and freeing up some of Italy's economic potential.

The best, and probably only, hope of stabilising the position in the eurozone in the short term is the ECB. We have already noted how its provision of vast amounts of liquidity, including three year money, has given some hope to the stock market. Some have suggested that this is a backdoor method of quantitative easing by providing funds against collateral of weakened quality so that banks can use the cheap borrowed funds to buy longer dated eurozone bonds and make a big turn. This might get round the problem of the ECB not being able to finance governments directly. Given the gravity of the situation, we believe that the ECB will buy more government debt in the market. Under its Securities Market Programme, it has bought €219 billion of eurozone bonds. It is important to make the point that these actions of the ECB are not in keeping with what it wanted to do but the situation is so serious that, of necessity, we believe that it will print money to buy up troubled eurozone sovereign bonds. This will not solve the fundamental problem and down the road lies currency debasement.

So, as indicated before, the outcome of the eurozone crisis will be either a full fiscal transfer area and effective central eurozone economic government or a partial, or total, break up with members reverting to their own currencies. The former outcome would mean unlimited and unending economic pain for many countries, whilst the latter outcome would be extremely messy in the short term, but with the prospect, in the longer term, that



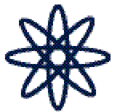
flexible currencies will restore competitiveness and therefore give some hope of renewed economic growth. Whatever the outcome, huge and unnecessary costs have been incurred.

Relating a lot of this theory to practice, we can see from the GDP figures and forecasts how damaging the crisis has been to some eurozone members. If we look at Eurostat's forecasts for 2011 growth where the actual level is not currently available, we see that the eurozone as a whole is expected to have grown by 1.5%, with Eurostat forecasting growth of just 0.5% in 2012. Of the major eurozone countries, Germany performed the best in 2011 with actual growth of 3.0%. However, the forecast for 2012 is just 0.8% and all these forecasts could be revised down again if there is a collapse of the eurozone. The effects of the austerity measures in place or planned can be seen in the forecasts for the number two and three economies in the eurozone, France and Italy. France is forecast to have grown by 1.6% in 2011 and Italy by 0.5%. Eurostat's forecasts for next year are 0.6% and 0.1% respectively. If we look at Greece, 2011 will have marked the fourth year of economic contraction with the forecast being for negative growth 5.5%. The forecast for 2012 is for a contraction of 2.8% but that feels optimistic given the way events are developing. Portugal is forecast to have contracted by 1.9% in 2011 and for the decline to worsen to 3.0% this year. Ireland is the eurozone country most likely to make a recovery from the crisis because of its flexible economy and early action to tackle its debt problems which were brought about by the collapse of its outsized banking system rather than lax public finances. It is forecast to have grown by 1.1% in 2011 and for the same outcome in 2012. Spain, also a concern, especially as it is the fourth largest eurozone economy, is forecast to have grown by 0.7% in 2011 and to grow by the same amount in 2012. With austerity measure upon austerity measure being piled on these countries, it would be no surprise to see even these anaemic growth forecasts downgraded to negative growth. It is a vicious spiral of decline which can emerge from a situation wherever increasing amounts of austerity are imposed on countries which are not reaching their deficit reduction targets.

Weak economic growth in the eurozone has an adverse effect everywhere but to varying degrees. Fortunately, there is enough strength in the rest of the world to prevent the world economy from moving into recession this year and, importantly, the US economy appears to have some modest momentum although it would be right not to put it any higher than that.

In its latest World Economic Outlook, the IMF estimates that world output will advance by 3.3% this year, down from 3.8% in 2011. The divergence between advanced economies and emerging and developing economies remains as stark as ever. The IMF is forecasting that advanced economies will grow by just 1.2% in 2012 against 1.6% in 2011, whereas its current projection is for emerging and developing economies to grow by 5.4% this year against 6.2% last year. Emerging and developing economies are so important to the world economy, nearly 50% of GDP, that their superior growth, even if not at the level of 2011, should be sufficient to keep the world economy growing. Within the advanced economies, the IMF predicts that the eurozone will contract by 0.5% this year. Within that prediction, its expectation is more pessimistic than Eurostat's because it expects the eurozone's no. 3 and no. 4 economies, Italy and Spain, to decline by 2.2% and 1.7% respectively this year. The USA is forecast to grow by 1.8% this year, Japan by 1.7%, the UK by 0.6% and Canada by 1.7%.

The drivers of growth are, as for some time, to be found elsewhere in emerging and developing economies. Although a modest slowdown in economic growth in 2012 in China and India, compared with 2011, is expected, growth will be at levels of which the major industrialised countries can only dream. The current IMF projection is for China to grow by 8.2% this year and India by 7.0%. The ASEAN-5 countries, Indonesia, Malaysia, Philippines, Thailand and Vietnam, are projected to grow by 5.2%. The financial strength of many of these countries in Asia and elsewhere, in countries like Brazil, means that they can carry out pro growth policies of various degrees compared with the austerity measures being inflicted on some members of the eurozone. These countries' requirements for the industrialised countries' exports will provide some support to world growth, albeit at not the same rate as in previous years as their rate of growth cools off.



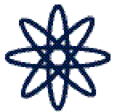
Since the start of the financial crisis, these reviews have moved more from the particular to the general in the sense that detailed economic and financial data on various countries and regions have seemed less relevant than the big story, which was, and is likely to be, more of an influence on markets. That is still the case, but recent market movements suggest that more attention is being paid to individual items of data, even against a background of such economic danger.

Starting first with the USA, the latest GDP data for the fourth quarter of 2011 shows annualised growth of 2.8% and year on year growth of 1.6%, not startlingly good, but at least some growth and a much better position than in the eurozone. The latest unemployment figure at 8.3%, a three year low, has given some cause for optimism, with 240,000 jobs being added in January, a much higher figure than expected. The level fell from 8.5% in December. Consumer sentiment is also looking better, with the latest University of Michigan index at 75.0 compared with 69.9 in December. To balance this, it should be said that the Conference Board's consumer confidence index was lower in January at 61.1 compared with 64.8 in December. Industrial production trended higher in December, up 0.4% month on month, and nearly 3% up year on year. The closely watched ISM index for manufacturing moved higher in January, up from 53.1 to 54.1, whilst that for services in December rose slightly from 52.6 to 53.0. The index of leading indicators moved slightly higher in December, up to 94.3 from 93.9 the previous month. In better days, these figures would have been regarded as unremarkable but, given the world economic background, investors have taken some encouragement from them and, following earlier signs of progress during the quarter, explain the relatively strong showing of the U.S. market.

The eurozone, of course, presents a different picture. The final quarter of 2011 is going to be very bad, as we know, with even Germany grinding to a halt, and negative growth in the most troubled countries with, according to the latest IMF projections, the follow through in 2012 being a 0.5% economic contraction for the eurozone. Confidence is low. Although the latest EU Economic Confidence index for the eurozone rose slightly between December and January, up from 92.8 to 93.4, the individual readings for the most troubled countries, except for Portugal, are lower. The same pattern is repeated for the EU's index of industrial confidence. The latest published figures for industrial production to the end of November showed a 0.1% fall for the eurozone on a month on month basis. On a year on year basis, the figure was 0.2% lower.

Economic data for Japan are distorted by the knock on effects of last March's earthquake and tsunami and, more recently, by the flooding in Thailand, which affected Japanese manufacturers badly. The latest quarter's GDP figures to the end of September showed a quarter on quarter rise in real GDP of 1.4% and a year on year fall of 0.7%. The latest industrial production figures for December showed a month on month increase of 4.0%, but a year on year decline of 4.1% reflecting the natural disasters of last March. The IMF's latest projection of economic growth of 1.7% in 2012, after its projection of a 0.9% fall in 2011, may more depend not only on what happens elsewhere in the world economy but also on the pace of recovery from last March's events, the floods in Thailand and the strength of the yen which has been unhelpful to many Japanese companies.

Key to the fortunes of the world economy is China. We have mentioned earlier the extent of the importance of developing and emerging economies. Everyone knows their influence, but the actual figures might surprise many people. The final quarter of 2012 is reported to have shown annualised quarter on quarter growth of 8.9%, down from 9.1% the previous quarter against year on year growth of 9.2%. One of the fears of the Chinese authorities was inflation, which has the potential to cause social instability, particularly if it related to food price inflation. There is better news on the inflation front. The year on year rate of inflation has fallen to 4.1% having recently peaked at 6.5% last July. Food price inflation is showing a year on year increase of 9.1%, having peaked at 14.8% last July. In terms of action taken to subdue the overall level of inflation, the authorities repeatedly raised bank reserve requirements and raised interest rates but in the face of a slowdown in the rate of economic growth have been slowly reversing these rises. But food price inflation is a big issue in a country where its leaders fear social unrest and there have been numerous increases in local minimum wages. Gradually, China is becoming a more



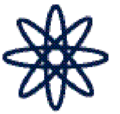
expensive place in which to manufacture and this is responsible for two discernible trends in their early stages, namely business moving to cheaper Asian countries and what is termed "reshoring", the movement of some manufacturing back to industrialised countries from which it was originally moved. So, China also has problems, but of a different nature and immediate magnitude to those of the west, particularly the eurozone and its overall impact is positive for the world economy in preventing a global, rather than localised, recession.

Although the UK has severe public and private debt issues, it has been rewarded for its structural deficit elimination plan by a substantial fall in its borrowing costs as evidenced by the level of government bond yields as shown in the table at the beginning of this review. Although the timetable for elimination of the structural deficit has been put back two years by the effect which the eurozone's debt problems have had on the global economy, the UK's plan is seen as one of the most credible around. As we have said on a number of occasions before, we believe that siren voices calling for a slowdown in the programme are ignoring the probable reaction of the markets, which we think would be severe for both the sterling bond market and currency. We do not think it is a realistic option. There are other reasons for low UK government bond yields. The first is a reflection of quantitative easing which has kept down government bond yields. The Bank of England holds around a quarter of outstanding gilt edged issues and that figure might move up to around a third depending upon when the quantitative easing programme eventually stops. Creating money to buy gilts has depressed yields and made funding the deficit relatively easy, particularly as the UK gilt edged market has attracted substantial foreign buying. The other reason could be a negative view about the UK's growth prospects which could make present yields acceptable. We certainly do not agree that they are acceptable.

Although there have been flickers of optimism in January with respect to some items of data, the economic situation in the UK remains very difficult. The first estimate of the final quarter of 2011's GDP showed quarter on quarter growth to be negative by 0.2% and for year on year growth to just 0.7%. The final quarter's estimate could be adjusted either way in later readings but this will not change the overall picture. Estimates for this year's growth have been falling as the eurozone's difficulties increase. The IMF's latest forecast suggests growth of just 0.6% in 2012. As the EU is the UK's biggest trading partner, the impact of the eurozone's economic woes within the EU is unhelpful.

Although this review deals mainly in economics, we should not ignore the political aspects. We should note the strong growth of anti business and wealth creation sentiment which is particularly prevalent amongst politicians in the UK, France and, to some extent, in the USA. In the UK, politicians of all parties seem to be competing with one another in this game. In France, the main opposition candidate for the Presidency is putting forward a number of measures which will not be helpful for the economy, such as an additional tax on banks and a rise in the rate of corporation tax for large companies. Whilst this may seem part and parcel of the way politicians operate in an attempt to secure election or re-election, the dangers of an accident happening increase all the time. For example, in the UK, one does not have to support the bonus culture which has existed in banks to realise that the exit of one major bank from the UK to another domicile would produce a severe and negative shock. Similarly, if the rate of corporation tax on large companies in France is raised to 35%, it is clearly not going to be beneficial to French economic activity. Whilst the politics may seem much less important than the economics in the present crisis, the corrosive effect of anti business sentiment, if it persists and is translated into action, will be negative for the stock markets of those countries where it is prevalent, and of corresponding benefit to those countries which will gain from the transfer of business. So, investors would be unwise to brush off this anti business sentiment as something which is harmless and will go away.

In conclusion, our investment stance has not changed. The economic background remains awful and there is the threat of the start of the break up of the euro. Good quality bonds, to us, represent very poor value because of their inadequate yields and the threat of inflation later on as a result of very loose monetary policy including, where instituted, quantitative easing. In one way, shares gain by default as bonds (and cash, if held as the main



asset class) look unattractive. But they also look to represent good value having modest earnings multiples and attractive yields especially relative to high quality bonds. Many international companies have excellent exposure to fast growing areas of the world and their experience in managing currency risks, should the eurozone start to break up, will be helpful. However, although markets are less volatile at the moment, it is bound to be an uneven ride, given how much bad news is around.

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 2012