meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

As a result of stronger market conditions in January, the weakness seen in December does not show in the quarterly returns and international equity markets ended little changed over the quarter. Bonds benefited from the volatility of equities and yields on high quality issues declined. In the foreign exchange market, sterling strengthened with the yen the only major currency which was stronger. In commodities, gold showed some of its defensive qualities. The fall in the price of oil over the quarter was significant.

The tables below detail relevant movements in markets :

International Equities 31.10.18 - 31.01.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.4	+1.3	+4.3	+3.0
Finland	+0.8	-0.9	+2.1	+0.8
France	-2.1	-3.7	-0.9	-2.1
Germany	-2.4	-4.0	-1.1	-2.4
Hong Kong, China	+14.6	+11.2	+14.5	+13.1
Italy	+4.0	+2.3	+5.3	+4.0
Japan	-4.1	-3.4	-0.6	-1.8
Netherlands	+0.7	-0.9	+2.0	+0.7
Spain	+3.2	+1.5	+4.5	+3.2
Switzerland	-0.7	-2.3	+0.6	-0.6
UK	-1.7	-1.7	+1.2	N/C
USA	+0.3	-2.6	+0.3	-0.9
All World Europe ex UK	-0.3	-1.9	+1.0	-0.3
All World Asia Pacific ex Japan	+6.9	+5.7	+8.9	+7.5
All World Asia Pacific	+2.3	+1.9	+4.9	+3.6
All World Latin America	+8.1	+8.6	+11.8	+10.4
All World All Emerging Markets	+7.1	+6.7	+9.9	+8.5
All World	+0.8	-1.1	+2.1	+0.5

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : 0.0%

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

Currency	31.10.18	31.01.19
Sterling	1.26	1.24
US Dollar	3.10	2.71
Yen	0.13	0.01
Germany (Euro)	0.30	0.08

Sterling's performance during the quarter ending 31.01.19 (%)

Currency	Quarter Ending 31.01.19
US Dollar	+2.9
Canadian Dollar	+2.8
Yen	-1.0
Euro	+1.6
Swiss Franc	+1.3
Australian Dollar	+0.1

Other currency movements during the quarter ending 31.01.19 (%)

Currency	Quarter Ending 31.01.19
US Dollar / Canadian Dollar	-0.1
US Dollar / Yen	-3.7
US Dollar / Euro	-1.3
Swiss Franc / Euro	+0.3
Euro / Yen	-2.5

Significant Commodities (US dollar terms) 31.10.18 - 31.01.19 (%)

Currency	Quarter Ending 31.01.19
Oil	-18.7
Gold	+7.0

MARKETS

It has been a volatile quarter for markets but a recovery in January meant that the end result for the quarter was little change. In local currency terms, the FTSE All World Index returned +0.8%, in sterling terms -1.1%, in US dollar terms +2.1% and, in euro terms, +0.5%. Looking at local currency returns first, the stand out performers were the FTSE All World Latin America Index which returned +8.1%, the FTSE All World All Emerging Markets Index which returned +7.1% and the FTSE All World Asia Pacific ex Japan Index which returned +6.9%. On the negative side, the two worst performers were the FTSE Japan Index which returned -4.1% and the FTSE UK Index which returned -1.7%. In sterling terms, the picture changed somewhat with the leading performers continuing to show up strongly but, because of the weakness of the US dollar, the FTSE USA Index moved from a local currency positive return of +0.3% to -2.6% in sterling terms. The FTSE All World Europe ex UK Index moved to an underperformance against the FTSE UK Index showing a negative return of -1.9%.

The volatility and falls in equity markets in the last quarter of 2018 encouraged a move into bonds and, taking ten year government benchmark bond yields, there was a decline in the gross redemption yield on the UK gilt of 2 basis points to 1.24%, in the US Treasury by 39 basis points to 2.71%, in the Japanese Government Bond by 12 basis points to 0.01% and in the German Bund by 22 basis points to 0.08%.

In the foreign exchange market, the strongest performer was the yen against which sterling fell by 1.0%. However, elsewhere, sterling was stronger, rising by 2.9% against the US dollar, by 2.8% against the Canadian dollar, by 1.6% against the euro, by 1.3% against the Swiss Franc and by 0.1% against the Australian dollar.

In the commodity markets, the feature was the 18.7% decline in the price of Brent crude, although this represented a recovery from the low point. Gold, on the other hand, saw its traditional safe haven status benefit its price during the market volatility and it ended the quarter 7.0% higher.

ECONOMICS

There has been a deterioration in the economic outlook although it is, as yet, uncertain whether this is a blip or something more. Particular areas of concern are the eurozone and China. The flip side of this is that central banks are likely to keep monetary policy looser for longer than they had previously anticipated. The IMF has just published an update to its World Economic Review which reflects weaker economic conditions. This, we should emphasise, does not mean that the world economy is facing a recession, rather, at this stage, it looks like a slowdown.

Compared with its October projections, the IMF now projects economic growth in 2019 at 3.5% against an estimate for 2018 of 3.7%. This new projection for 2019 is 0.2% lower than the one the IMF made last October. If we look at a breakdown of the figures we see that it has cut the projection for Advanced Economies for 2019 to 2.0%, 0.1% lower than the level previously estimated. Growth for 2018 is estimated to have been 2.3%. The IMF has made no change in its forecast for the USA with the 2019 growth rate estimated to be 2.5% against an estimated 2.9% in 2018. The eurozone, however, has seen a significant reduction in projected growth in 2019, down to 1.6% compared to its October estimate of 1.9% and slightly lower than its expected outcome for 2018 of 1.8%. The biggest setback is projected to occur in the powerhouse of the eurozone economy, Germany, where the IMF has slashed its 2019 projection by 0.6% to 1.3% which, if it materialises, would be a lower level than that expected for 2018, 1.5%. The reduction for France has been more modest, just 0.1%, which would be the same level as for the expected outcome for 2018. The third largest eurozone economy, Italy, like Germany, has seen a large downgrading in its projected growth for 2019. The IMF has downgraded 2019's projection by 0.4% for 2019 to 0.6% against an estimated 1.0% for 2018. The fourth largest eurozone economy, Spain, on the other hand has seen no downgrading in expectation with the IMF still seeing 2.2% growth this year which compares with estimates of 2.5% for 2018. The IMF has left unchanged its projected growth in 2019 for the UK at 1.5% which would be a slight improvement of its estimated outcome for 2018 of 1.4%. It is ironic that, for all the scares about Brexit, the IMF projects a faster growth rate in 2019 for the UK compared with Germany. It must be emphasised that its UK forecast is subject to substantial uncertainty and assumes a Brexit deal in 2019 and, as this is written, the uncertainty remains enormous. Of the other G7 countries, Japan has seen an upgrade in its 2019 growth estimate to 1.1% which is a 0.2% increase on the IMF's earlier forecast. Canada has seen a slight reduction in its projected growth for 2019, down 0.1% to 1.9%.

Moving to the IMF's projections for 2019 for Emerging Market and Developing Economies, the IMF has lowered its October projections by 0.2% to 4.5%, still well ahead of that for Advanced Economies. It has left its projection for 2019 growth for China unchanged at 6.2% which would be a meaningful reduction on the expected outcome for 2018 of 6.6%. For India, there has been a slight uplift for this year of 0.1% to 7.5% (this is for its fiscal year). The main areas contributing to the weaker forecast for this bloc of countries is Mexico (a reduction of 0.4% to 2.1%), Saudi Arabia (a reduction of 0.6% to 1.8%) and Nigeria (a reduction of 0.3% to 2.0%). All of these, of course, are oil producing countries.

None of these reduced forecasts are alarming until we know more, but they are concerning to a certain extent. We can easily speculate why there may be a slowdown and increasing uncertainty. Probably, top of the list is the trade dispute between the USA and China. Before it is escalates further, there is a breathing space until the end of February whilst further negotiations take place. At present, apart from earlier tariffs on solar panels, washing machines, aluminum and steel, announced in the first half of 2018, there is a 10% tariff on US$200 billion of imports from China which, if agreement cannot be reached by the end of February, will rise to 25%. US$60 billion worth of Chinese imports from the USA are subject to 5% or 10% tariffs. President Trump has threatened tariffs on the remaining US$267 billion of Chinese imports. None of this is good news as trade wars can only slow down growth or even lead to a recession as world trade slows down and economic inefficiencies creep into the system. In a rational world, and politicians are not always rational, politicians would step back from such risky policies and, in our investment thinking, we have to give them the benefit of the doubt but, on this occasion, there is more uncertainty than usual. President Trump took credit for Wall Street's record breaking run last year so, although he would not say it, he must be aware that the reverse is true. He is over half way through his first term of office and he has ground to make up judging by the mid term elections. Apart from that setback, he has had to back down over the partial shutdown of government so it would not seem sensible to court a recession by going toe to toe with China over tariffs. The effect on the tariff imposition is already appearing in some US companies' results and this may resonate with the President who is, after all, a businessman. In China, President Xi has accumulated an enormous amount of power for himself. The downside of that is that when something goes wrong, attention will be focused on him. China is undergoing a change as the government tries to move the economy away from a fixed asset and export bias towards consumption and services which will result in a slowdown in the rate of economic growth, albeit that it should be of better quality. Yet the economy has to keep growing at a fast rate (by developed countries' standards) to keep unemployment from rising. At the same time, whilst juggling with this balancing act, the authorities have tried to reduce the amount of leverage in the economy through clamping down on the shadow banking sector. But along comes the USA's tariffs, which are affecting the Chinese economy, resulting in the need to stimulate the economy by cutting the banks' reserve requirements and encouraging them to lend to small and medium enterprises. All this creates an awkward bind for the Chinese authorities forcing them to take measures (loosening banks' reserves requirements) which they would not want to have done in normal circumstances. The President cannot be seen to back down and lose face but, even more important, he cannot preside over an economy where the growth rate is falling sharply. So the position in which President Trump and President Xi find themselves is a difficult one and there is every incentive for them both to find an honourable way out of this impasse in which neither is seen to be the loser. This seems the most likely outcome but political decisions are not always rational ones. We think that it would be dangerous to change our investment policy to one which is predicated on the worst outcome because it is more likely that pragmatism will win out at the end of the day.

However, the eurozone has become a problem as growth appears to have slowed quite sharply. The Purchasing Managers Indices, which are a closely watched indicator of economic health, do not generally make for good reading. The latest eurozone composite index stands at 50.7, a level which points to very little growth, with the services PMI at 50.8 and that for manufacturing at 50.5. The German composite PMI stands at 52.1. Whilst the services component is in modest positive territory, 53.1, the manufacturing index is in negative territory at 49.9. Look back a year and the respective index levels were 59.0, 57.3 and 61.1, quite a dramatic decline. Those for the eurozone as a whole were broadly similar at 58.8, 58.0 and 59.6. France's PMIs are dramatically bad. The composite PMI at 47.8 signals economic contraction. In the case of France, the services PMI makes very bad reading, standing at 47.5. The manufacturing PMI is a little better, standing at 51.2 and given that these are the two largest economies in the eurozone, the figures do not augur very well for the area. Slightly moving into the background, but still a danger for the eurozone, is the Italian budget with its threat to the Stability and Growth Pact. A compromise between the Italian government and the EU has been reached on the size of this year's budget deficit at 2.04% of GDP but it is predicated on a growth rate which is considered very optimistic by many observers and, if the growth rate is not achieved, revenues will not meet targets. All of this was a concern before the French crisis developed with the gilets jaunes taking to the streets. The gilets jaunes have had to be bought off by the President and France's budget deficit is expected to be around 3.4% of GDP this year, well over the allowed 3.0% limit. Nobody, however, expects France to be sanctioned for the breach. There are two main reasons for the sudden decline in Germany's economic growth. The important car industry has been affected by the new emissions tests which are required and the aftermath of the diesel scandal, whilst its export orientated economy is being affected by the slowdown in world trade.

A third issue for the eurozone, which leads on to a more general issue for investors, is the course of monetary policy. At the beginning of last year, we thought that one of the major challenges for stock markets would be how a tightening of monetary policy, as central banks tried to take small steps back to normality, would affect markets. The ideal position would have been where economic and corporate earnings growth were good enough to offset higher interest rates. From an economic perspective, it is important that interest rates do move towards more normal levels, even if that normal level is not as high as in the past. The reason for the importance of interest rates moving towards more normal levels is twofold. Firstly, some monetary ammunition is needed to provide a stimulus when an economy needs it, i.e. the ability to reduce interest rates and, secondly, to start to eliminate economic distortions caused by ultra low interest rates. Central banks are moving at a different pace in their attempts to achieve some sort of normality. The Federal Reserve in the USA has moved the furthest with nine interest rate increases since their low point in this cycle plus a move to Quantitative Tightening (QT) which is reducing the size of its balance sheet. This has happened at a time when US corporate earnings have risen rapidly (over 20% last year) which goes some way to explain the relative strength of the US equity market in 2018. But at least with the target federal funds rate at 2.25% to 2.5%, there is some scope to reduce them if the US economy needed a stimulus. The expectation now is that there will be two more interest rate increases this year, although the actual timing and movement will be data dependent. For the eurozone, however, the interest rate question is problematic. With zero per cent interest rates, there is no scope to stimulate the eurozone economy that way. The decision to end quantitative easing at the end of 2018 completely, after a period during which the rate of QE slowed, it now looks questionable as it has coincided with weakness in the area as described above. Whilst the ECB is not reducing the size of its balance sheet because it is reinvesting the proceeds of maturing assets, it is not creating electronic money to buy further assets so this reflects some tightening of monetary policy, albeit from a very loose base. However, one has to ask the question as to why the eurozone is showing a relatively poor performance after such a significant amount of QE. It looks as if it finds it hard to produce economic growth without this artificial stimulus and it suggests, almost certainly correctly, significant structural problems within the area. There is no question that policy makers in the eurozone, whether it be the ECB on the monetary side or the EU on the political side, are going to face some difficult decisions. Does the ECB accept that the only way for the area to be able to show even modest economic growth is to keep interest rates low and start QE again with the risks that an even larger central bank balance sheet entails? As we have often said, the euro is an artificially created currency without proper political and economic foundations and is not an optimal currency area. One more financial or economic crisis could cause the eurozone to disintegrate without proper underpinnings being in place. If economic growth within the eurozone slows down, a number of members' fiscal positons will deteriorate. Does the EU sanction countries like France and Italy? If not, where is the credibility of the currency?

Whilst the US economy still seems to be in relatively good order, although not unscathed by the trade wars, the Chinese economy, by its own standards, is having a difficult time, albeit at a high level of growth compared with developed countries. We have touched upon this earlier in our review, but it is important because of the knock on effect it can have elsewhere. For example, Apple's iPhone business has been suffering in China. The latest PMIs from China show manufacturing to be relatively weak with its index standing at 49.5 and the services one at 54.7. After the financial crisis in 2008, China provided an enormous stimulus to its economy which proved beneficial for the world economy but this time it does not have as much firepower, with much higher levels of leverage in the economy. What this proves is that a satisfactory resolution of the trade dispute with the USA is very important. For foreign investors, the opening up of the "A" share market and inclusion in the MSCI Emerging Markets Index means that there will be more natural buyers of Chinese "A" shares. However, 2018 was a very bad year for the Chinese stock market and the opening up of the market has coincided with official moves to establish the Communist Party even more strongly in companies and the concern is that Chinese companies, even private ones, will become tools of official policy at the expense of creating shareholder value. But, for the moment, it is the trade issue which has to be uppermost in investors' minds.

We cannot end this review without talking about Brexit. As clients know, we regard the UK as a high risk market and have a low weighting as a result. The reason for this is the level of uncertainty surrounding the political situation. Although, if there is a WTO exit (no deal), there would be some short term disruption, prospects beyond that could look much better and the UK is one of the more flexible developed economies. The danger arises from Brexit leading indirectly to a change of government. We do not generally discuss political issues in our reviews but politics is as important as economics in defining investment strategy and the economic policies espoused by the UK Opposition would, as articulated so far, be so far removed from policies followed in the past that we believe it would be inevitable that the UK stock market and currency would fall, probably quite sharply. Whilst the Fixed Term Parliament Act makes it less likely that there will be a General Election before its next due date in May 2022, it cannot be discounted. Even if the chance of a change of government is less than 50%, the high weighting that one has to give it for the risk makes it important to factor this point into an investment strategy and hold a substantial percentage in overseas assets, effectively an insurance policy which would "pay out" from the highly probable relative outperformance of foreign stock markets and currencies in such circumstances. At present, it is almost impossible to tell how events will unfold in the UK and we prefer not to take the risk of being overexposed to the UK. This is unfortunate because, without the political risks, the UK would look an attractive stock market. For example, the economy is relatively strong with unemployment low and wages rising faster than inflation. It stands in good comparison with many European economies as the IMF projections, although hedged with uncertainty, show.

It is important that investors are not intimidated into making unwise investment decisions based on the kind of febrile atmosphere which was seen in the final quarter of 2018. Increased volatility is unsettling, but it is important to stand back and look at what is really happening. One has to judge the risks, which are always around, but also the costs of holding a high percentage of cash if markets rise, as they do more often than they fall. We have seen in January a much steadier performance from international equity markets and volatility has reduced. It is realistic to expect some more quarterly setbacks against the background of a rising medium term trend unless a recession intervenes. That needs to be monitored but the immediate outlook is for modest economic growth, albeit not at 2018's rate. Bonds, which benefited from recent market turbulence, still look very expensive.