meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

In local currency terms, international equity markets have mostly moved higher during the last quarter to provide, except for euro based investors, a satisfactory return. Bond yields, as measured by ten year government benchmarks, have generally drifted higher except in the U.S.A. There have been some significant moves in the currency markets with the strength of the euro against the US dollar being a particular feature. In the commodity markets, there was little change in the oil and gold prices.

The tables below detail relevant movements in markets :

International Equities 28.04.17 - 31.07.17

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-2.9	+1.7	+3.7	-4.3
Finland	+0.7	+7.0	+9.1	+0.7
France	-0.9	+5.3	+7.3	-0.9
Germany	-2.1	+4.0	+6.0	-2.1
Hong Kong, China	+7.4	+5.4	+7.4	-0.8
Italy	+6.6	+13.2	+15.4	+6.6
Japan	+5.3	+4.2	+6.2	-1.9
Netherlands	+2.2	+8.5	+10.6	+2.2
Spain	-0.6	+5.6	+7.6	-0.6
Switzerland	+3.1	+3.4	+6.4	-1.8
UK	+3.0	+3.0	+4.9	-3.1
USA	+4.1	+2.2	+4.1	-3.9
All World Europe ex UK	+0.6	+6.0	+8.0	-0.2
All World Asia Pacific ex Japan	+6.9	+6.8	+8.8	+0.5
All World Asia Pacific	+6.3	+5.7	+7.7	-0.5
All World Latin America	+2.8	+4.2	+6.2	-1.9
All World All Emerging Markets	+7.1	+6.2	+8.2	-0.1
All World	+3.7	+3.6	+5.6	-2.5

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : -1.2%

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

Currency	28.4.17	31.07.17
Sterling	1.17	1.29
US Dollar	2.30	2.30
Yen	0.01	0.08
Germany (Euro)	0.34	0.55

Sterling's performance during the quarter ending 31.07.17 (%)

Currency	Quarter Ending 31.07.17
US Dollar	+1.9
Canadian Dollar	-6.8
Yen	+0.9
Euro	-6.0
Swiss Franc	-0.9
Australian Dollar	-4.5

Other currency movements during the quarter ending 31.07.17 (%)

Currency	Quarter Ending 31.07.17
US Dollar / Canadian Dollar	-8.5
US Dollar / Yen	-0.9
US Dollar / Euro	-7.3
Swiss Franc / Euro	-5.1
Euro / Yen	+6.9

Significant Commodities (US dollar terms) 28.04.17 - 31.07.17 (%)

Currency	Quarter Ending 31.07.17
Oil	+0.4
Gold	+0.1

MARKETS

Except for euro based investors, it has been a quarter of solid, but not spectacular, returns. In local currency terms, the FTSE All World Index has returned +3.7%, in sterling terms +3.6%, in U.S. dollar terms +5.6% and in euro terms -2.5%. Looking at individual areas in local currency terms, the strongest performers were Emerging Markets, where the FTSE All World All Emerging Markets Index returned +7.1%, the FTSE All World Asia Pacific ex Japan Index which returned +6.9%, the FTSE Asia Pacific Index (which includes Japan) which returned +6.3% and the FTSE Japan Index which returned +5.3%. The most significant areas of underperformers were Australia where the FTSE Australia Index returned -2.9% and Europe ex UK where the FTSE All World Europe ex UK Index returned +0.6%. However, currency movements affected sterling returns significantly. The low local currency returns on the FTSE All World Europe ex UK Index became a strong return of 6.0% in sterling adjusted terms. The negative local currency return on the FTSE Australia Index became a positive one in sterling terms, +1.7%. In sterling terms, the FTSE USA Index became a slight underperformer with a return of +2.2% against a slightly above average return in local currency terms of +4.1%. The FTSE All World Asia Pacific ex Japan and FTSE All World All Emerging Markets Indices still held up well in sterling terms with total returns respectively of +6.8% and +6.2%.

In the international government bond markets, taking 10 year benchmark yields, prices generally drifted lower. The gross redemption yield on the UK government bond rose by 12 basis points to 1.29%, on the Japanese Government Bond by 7 basis points to 0.08%, on the German Bund by 21 basis points to 0.55% whilst it remained unchanged on the US Treasury bond at 2.30%.

As implied above, currency movements were quite significant over the quarter. Against the Canadian dollar, sterling fell by 6.8%, against the euro by 6.0%, against the Australian dollar by 4.5% and against the Swiss Franc by 0.9%. On the other hand, it rose by 1.9% against the US dollar and 0.9% against the yen.

There was little change in the prices of oil and gold over the quarter.

ECONOMICS

It was as recently as the second week of July that the annual G20 summit took place in Germany with the world’s most important leaders meeting to discuss top table global order matters against the usual backdrop of photo opportunities and protests. It can be quite difficult to judge how much progress is made at such events with priorities such as how to best deal with North Korea’s ‘ambitious’ leader Kim Yong Un being a case in point. The tacit acknowledgement of the increasingly difficult politics of that corner of the globe was more significant than the need to agree on a strategy and the matter remains to be resolved. Changing forces seem to be affecting the foreign offices of leading countries’ administrations with China flexing its muscles and Trumpian America less willing to join any international jamborees. The countries of Europe are busy working for a strong and stable future without the UK and may have less time to spend on the world stage and Japan, outwardly, looks inwardly. Donald Trump has wanted to catapault the ‘unfairness’ of cross border trade on to his country’s agenda and relative currency strength gets drawn into this discussion though at the present time a marked escalation of trade barriers looks unlikely. Looking at the FTSE All-World Index in local currencies on a total return basis, a benchmark we commonly use, we have now seen nine months of rising markets, from November 2016 to July 2017 inclusive. Should we more worried about the levels of the markets or should we less worried about the politics of the world? Investors have seemed, with increasing ease, to be able to shrug off the political uncertainties which pass and prevail at any time and volatility, a usually accurate indicator of sensitivity to external factors, continues to be low by historic standards. Markets remain at, or near, all-time highs and investor confidence in 2017 appears to be supported by the two most important factors - earnings growth and world economic growth.

The ongoing rise in markets over the past five years has been described as a reluctant bull market with suspicion abounding over the foundations on which this growth has been built. It would seem that this suspicion centres on the artificially low interest environment which has inflated asset prices with anything that looks like a bond being invested in like a bond, in the absence of bonds as a prudent investment. To this can be added the effect of share buy backs where over $2 trillion of corporate cash has been spent in the United States alone buying shares back from the market which has had the effect of concentrating the price/earnings ratio of the companies concerned. It is difficult to gauge the relative contribution of causal elements in something as human as suspicion but to these can also be added terrorism, electoral shocks and surprise in the magnitude of the market recovery from the dark days of 2009. The purpose of this monthly memorandum is to provide some insight into the thinking at Meridian and a part of that is an ongoing exploration of the macroeconomic environment in which constituent companies within our portfolios operate. Our belief remains that the finance directors of the international businesses in which we invest are more interested in the economics of the world than the politics though the two do not, of course, exist in isolation from each other.

We are at a telling stage in economic terms. The financial crisis is fading in the memory and in two months' time the collapse of Northern Rock will be a full ten years ago. The reaction and coordinated response from government and central banks prevented a very bad situation from being even worse - though to many that may be difficult to imagine and the economic fallout continues to affect most countries as the rise in indebtedness has driven government austerity which has fuelled social divide or the perception of social divide, depending on your view. Globally, economic growth is neither healthy nor anaemic and inflation is making a relatively welcome return, although more subdued than expected recently.

The theme of financial stability was covered by William Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the annual general meeting of the Bank for International Settlements on 25th June. He highlighted the unwelcome effects of a stressed financial sector where banks are unable or unwilling to intermediate credit between lenders and borrowers and the consequential influence that central banks have on the banking sector in such times. It goes without saying that those times are exactly the time when central banks wish to have maximum influence. It is important to note that the period following the collapse of Lehman Brothers was characterised by a sharp downturn in the demand for credit but a fundamental part of that was the lack of confidence which, once gone, is very difficult to propagate. Zero-bound interest rates have helped to stimulate demand for credit, as evidenced by the rapid build-up of debt in many countries, but debt creation does not automatically translate into economic expansion. This period could be described as the decade where debt has expanded the most, with the smallest corresponding relative expansion of world GDP. This decade has also been notable for the prominence of central bankers as they have sought to be the confidence-inspiring strong hand at the tiller.

He notes that banks, however, do now have significantly higher reserves of capital and liquidity, have changed their funding models to rely less on short term deposits and other short dated liabilities. Furthermore derivative markets have been reformed and there is now far greater clarity on 'resolution and recovery regimes' for banks and other key market participants for times when things go wrong. Dudley goes on to highlight the additional reforms which have been imposed upon the U.S. banking sector, which was the epicentre of the financial crisis, such as the Comprehensive Capital Analysis and Review regime. Under this, all systemically important banks are subject to annual capital stress tests. June also saw the results of this year's tests and was the first such test where all banks passed, albeit with one smaller bank only achieving a conditional pass.

The importance of this subject of financial stability is not to be underestimated just because of the number of years since the financial crisis nor the sense of comfort created by the years of relative calm since those troubling times. The potential for a further episode of financial turmoil remains with us given the ongoing accumulation of debt across the globe as we move into a period of tighter monetary policy, characterised by reduced quantitative easing and rising interest rates. It should also be remembered that the massive coordinated response to the crisis, quantitative easing, was never planned as a solution to all that was wrong but, rather, was to buy time for governments to implement fiscal and structural changes which would return the world economy to full health and keep it there. It is increasingly widely accepted that this period of ultra-loose monetary policy is coming to an end though it is not widely accepted that comprehensive fiscal and structural change has happened. Central bankers have also been obliged to fly blind in that the scale of their actions has no reference in history and, much like laboratory scientists, economists and central bankers do like to scour the history books for similar events to consider and learn from their outcomes. As policy reverses direction this lack of precedence applies equally to the future.

William Dudley reminds us in his remarks that the Federal Reserve is legally bound by the mandate given to it by Congress. It has two reference targets - maximum employment and price stability and it cannot subordinate this mandate for alternative international goals. His defence of this stance is that the most important cross-border contribution that the Federal Reserve can make is by promoting economic growth and financial stability within its borders. Confidence in the U.S. dollar is particularly important because of its status as global reserve currency i.e. it is widely held by every other country as part of their foreign reserves. This is important as America consistently runs a trade deficit meaning that trading partners need to be prepared to accumulate and hold the dollars they receive for consistently selling more to America than they pay for American goods and services. According to the International Monetary Fund, U.S. dollars constitute 63% of countries' foreign exchange reserves, almost triple the next closest currency, the euro, at 22%.

The central bank of the United States is far from alone in having a mandate set by its home government which is defined by domestic goals but we must reflect that cross border trade now accounts for around 45% of world GDP, which compares with around 17% in 1960, meaning that a coordinated response is in everybody's interest. The two largest currency areas are the dollar and the euro and it now looks like, in terms of monetary policy, the direction of travel is the same for both. This contrasts with three years ago when the Fed had started to taper its asset purchases and expectations were for a rise in interest rates. At the same time, the European Central Bank had cut its policy rate, announced support for companies and it embarked on substantial asset purchases at the start of 2015. This is significant because of the risks associated with a strong dollar, especially in emerging markets where much borrowing is denominated in dollars. More recently, the greenback was experiencing the compounded effect of Trump-inspired optimism regarding the economy and tightening monetary policy as higher inflationary pressures built with the euro falling to as low as $1.04 in December 2016 - a thirteen year low. In March 2014 a euro was worth as much as $1.39. Since last December factors on both sides have helped the euro gain value, a more hawkish ECB, renewed confidence in Europe spurred by the election of Emmanuel Macron in France and slightly lower economic expectations in the U.S. At the time of writing one euro is worth around $1.18. Some stability in this currency pair would be welcomed.

We will return to France, as it is topical, but any consideration of the build-up of debt levels should make passing reference to China. The credit rating agency Moody's downgraded China's credit rating in May by one notch to A1 from Aa3 or, in the language of other rating agencies, to A+ from AA-. The agency questioned how successfully the government can rein in leverage while maintaining the level of economic growth. The two are closely linked because debt management in a fast growing economy is far easier than in a slow growing one. Moody's cited the likelihood of a "material rise" in economy-wide debt and the burden it will place on the state's finances. China's official response was that Moody's had overestimated its difficulties and underestimated the government's ability to deepen reform and boost demand. China is a poor country on a per capita basis but a rich country as a nation. According to Bloomberg, total outstanding credit climbed to about 260% of GDP at end of 2016, up from 160% in 2008. This is a monumental rise given that GDP has almost trebled over that period. External debt is very low by international standards at around 12% of GDP meaning a downgrade is not such a big factor as there is no risk that a loss of confidence amongst international investors could trigger a slump in demand. Depending on foreign demand for a country's assets was recently described by the Bank of England's Mark Carney as relying on 'the kindness of strangers'. Supporting the Chinese government's position is the fact that real economic growth in the second quarter was 6.9% (annualised). This reduces the debt burden and factory price inflation means that profits at struggling state-owned industries improve, making debt affordability better. Nominal growth, ignoring the effect of inflation, was 11.1% which illustrates the capacity of the country to reduce its debt burden by increasing the size of its economy. There is awareness of growing risks within the Communist Party and sensitivity to risk is high with the twice-in-a-decade Party Congress in the autumn. President Xi Jinping has warned regulators that failing to spot and deal with risks in a timely manner would amount to a "dereliction of duty". Statements such as this from the party leader tend to focus minds. As was said in relation to monetary policy over the last decade, economists have no historic reference point for the rise of a new economic giant in such a short period of time. China's goals, its foreign policy, its transition towards an economy driven by internal demand and its 'One Belt, One Road' infrastructure programme show the unbridled ambition of this old country with a young economy and the ability of direct politics rule to get things done. Debt manageability will continue on both sides. Policy will continue to drive GDP higher - the so-called denominator effect, whilst new policy is tackling the shadow banking sector, shorthand for all of the lending that goes on outside of banks. At the moment, the risks seem contained with good levels of growth in industrial output, fixed asset investment and retail sales all underwriting expansion and what is good for China is good for the world, such are the effects its growth has on commodity markets, its direct neighbours and its contribution to the global GDP growth figure, given 2% growth in so much of the developed world.

In the IMF's July update, this 2% figure for 'Advanced Economies' for 2017 was affirmed having first made this estimate in its April World Economic Outlook projections. Significantly the contribution made by different economic units was revised with the United States having its estimate reduced from 2.2% to 2.0% whilst the euro area had its projection increased by the same margin to 1.9% with Italy and Spain receiving the largest increase, both being raised by 0.5 percentage points. In market terms European equities in 2017 have enjoyed a strong phase of growth marked by Emmanuel Macron's victory in the first round of the French Presidential election on 23rd April. At the beginning of 2017 the French Presidential elections were four months away and Emmanuel Macron was in third place in the polls. This was not the best place to be as it is a two round contest with the first and second place candidates after the first round facing off in the second round, but he benefitted from the misfortune of others, namely the establishment centre right pick François Fillon whose appeal at the time was due to many policies usually associated with the right rather than the centre right. Whilst lessons on successful electioneering can be learnt from the U.K.'s general election in June, there was much to admire in Macron's campaign. He ran with optimistic vision, drew on the need to confront unpopular themes, such as labour market reform, and was convincing on the benefits of a strong France within the European Union. His reward has been a shake-up of the political model with the Socialist Party almost wiped out in the Assemblée Nationale; its candidate came fifth in the first round of the presidential election, with the party having come first or second every time since 1974, bar one occasion when it came third. By that date in April it was fairly clear that Macron would become president and the result spells a higher degree of economic certainty than over the vanquished National Front leader, Marine Le Pen.

The task which the IMF has, amongst others, is the near impossible job of reading the tea leaves of economic forecasting. Whilst the election in France and the consequences for the euro area of Marine Le Pen not winning are easier to work with, the United States can be used as a good current example of this inexact science. In the July Update, its growth forecast for the U.S. has been reduced to 2.1%

for 2017, from 2.3%, and to 2.1% from 2.5% for 2018. To an extent this reverses the optimism dialed into earlier estimates and now reflects the current political outlook. Now, six months into his term, his achievements can be listed as follows: he authorised the building of the Keystone and XL oil pipelines, nominated conservative Neil Gorsuch to the Supreme Court, got the U.S. out of the Trans Pacific Partnership and seeks to renegotiate the North American Free Trade Area, chose not to sign up to the Paris Climate Treaty and stopped the closure of some of America's coal-fired power stations. A greater economic good would be derived from a list including comprehensive deregulation, tax reform and significant infrastructure spend, which were all promised but have proven harder to deliver. At best, it is a case of needing patience. A US dollar was worth €0.955 at the beginning of the year and at 31st July was worth €0.847. A pound was worth $1.2290 on the first trading day of the year and, again, by the end of July was worth $1.3190. Nine months ago Trump's then-election team produced a factsheet which forecast that tax cuts and deregulation would boost average GDP growth to 3.5% and "create as many as 25 million new jobs" in the next decade. In the context of this IMF growth downgrade it is also worth reflecting on the overall tone of the Update which was titled "A Firming Recovery". It outlines a changing mix but confirms its April projections of 3.5% global GDP growth in 2017 and 3.6% in 2018. US growth will be lower but the compensatory 'extra' growth comes in Japan and, especially, the euro area. China's growth projections are also revised up against falls in Brazil, Russia and India. Splitting the world in two, the growth forecast for advanced economies for this year is now 2.0% (unchanged from April) and 4.6% for emerging and developing economies (up 0.1% from April). A metaphor that is currently being used is that the world economy is firing on more cylinders, with the breadth of countries experiencing improving growth increasing.

Some might argue that caution and equity investing are mutually exclusive. Our view is that the uncertainty in equity outcomes is partly a function of timescale and is also mitigated by choosing to invest long term, to avoid dumping stock in difficult times and also shun speculative positions. Risk is also relative and the traditional perception that equities are a far higher risk than bonds is something that we have challenged for some time and have no reason to moderate that view at this time. If anything, we feel that investors should be considering any bond holdings in the light of the changing market conditions. If an exam question asked to list the conditions necessary to create the strongest bond market (measured by high prices and low yields) it would be hard not to give a model answer much different from the present situation. This has been covered in previous memoranda but these extraordinary factors are increasingly likely to change in the short to medium term. It is unusual for interest rates to remain at the same level for any long period of time as the economy is cyclical and interest rates are useful tools to create headwinds or tailwinds for growth. This notwithstanding, interest rates have been held at a stable level for some years - but only because they reached a lower limit in their effectiveness as a monetary tool. Quantitative easing now means that central banks hold around $15 trillion of bonds on their balance sheets. Newly printed money accounts for most of these bond purchases and central banks are still printing money at a rate of around $1.5 trillion per year. The European Central Bank alone will buy around $630 billion of bonds this year, on the current run rate. Interest rate policy has driven down short term interest rates and quantitative easing has lowered longer terms rates meaning a relatively flat yield curve.

The Federal Reserve said in June that it would gradually begin selling its gigantic holding of bonds effectively in a less obvious way by not reinvesting all of its maturing bond proceeds and coupons; it has also been slowly raising interest rates. At the beginning of July, the [central] Bank of Canada raised interest rates for the first time in seven years whilst the ECB and the Bank of Japan are suggesting that some slowdown in their programmes is likely. Referring back to the model exam question answer, a massive new buyer (all central banks collectively) in the market would distort prices, especially if they are prepared to buy regardless of price. Implicit in any normal market is that participants are price sensitive. A further factor would be the investor's choice of alternatives to bonds and the difference between nominal rates and real rates i.e. inflation and inflation expectations. What is clear from this brief synopsis is that there will be structural change in the market where there is a high likelihood that the $1.5 trillion per year spent on bonds will reduce and central banks will have maturing bonds which, increasingly, will not be replaced, the yield curve will steepen and shift upwards, meaning that short term rates will rise but long term rates will rise more as inflation expectations increase. On the supply side, net government issuance from the United States, eurozone and Japan is forecast to turn positive in 2018 and 2019 meaning that both net supply to the market will be increasing at the same time as aggregate demand falls. The extent to which this is a risk is, as always, difficult to quantify but it clearly puts central banks in the position of being potential negative catalysts. After many years of cutting interest rates and buying assets, which has been seen as stimulatory and positive for investors, we may now be entering a period where the opposite is true. It is of some comfort that inflationary pressures remain low in historic terms and poor productivity growth, high debt levels and an increasingly aged population may insulate against sharp rises. Equally, low unemployment levels in the U.S., Japan, Germany and U.K. do not seem to be creating inflationary pressures, so, at present, central bankers have some breathing space which gives them time to clearly signal future policy, something that is vitally important. Individual bonds are not exchange traded and so liquidity can rapidly dry up if confidence evaporates.

This memorandum started with the assertion that, at most times, the politics of the world has less effect on market movements than we might first expect and various elections and referendums over the last couple of years are good examples of that. Drawing together some of the other points raised earlier, world growth is on a weakly positive trend, with the next two years looking like being better than the last two but not reaching pre-crisis expansion levels. There is a need to normalise interest rates, where normalise may be a better word than raise. We are likely to remain in a low interest rate, low inflation environment for some years given the concerns over rising debt servicing costs and central bankers will need to ensure that money and credit supply growth are not impacted by tightening monetary policy as well as being hyper-sensitive to risk asset price movements, as bond markets could show vulnerabilities that have been latent for some time. Equities, whilst less cheap than in the past, continue to be supported by the growth trend and U.S. earnings results in Q1 and now Q2 have both beaten expectations with second quarter earnings supporting valuations by growing 9.1%, up from a projection of 8.0% at the beginning of July. Ultimately, any business's share price can only be viewed in the light of probable future income flows and the company's ability to convert those into profit. This will, of course, be affected from year to year by the political weather but the economic climate in the medium to long term is a more important consideration.