meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Because of the current circumstances, we are producing an abbreviated version of our regular economic review. We hope you will understand why it is necessary. We are aiming to restore the normal format shortly.

Selected International Equities Indices 30.04.20 - 31.07.20

Total Return Performances (£ terms)	**%**
UK	+0.6
USA	+9.3
All World Europe ex UK	+11.8
Japan	-0.2
Australia	+13.0
All World Asia Pacific ex Japan	+12.4
All World All Emerging Markets	+13.6
All World	+9.0

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : N/C

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

Currency	30.04.20	31.07.20
Sterling	0.23	0.10
US Dollar	0.61	0.53
Yen	-0.04	0.01
Germany (Euro)	-0.59	-0.53

Sterling's performance during the quarter ending 31.07.20 (%)

Currency	Quarter Ending 31.07.20
US Dollar	+4.0
Canadian Dollar	-0.1
Yen	+2.9
Euro	-3.3
Swiss Franc	-1.6
Australian Dollar	-5.6

Other currency movements during the quarter ending 31.07.20 (%)

Currency	Quarter Ending 31.07.20
US Dollar / Canadian Dollar	-3.7
US Dollar / Yen	-1.0
US Dollar / Euro	-7.2
Swiss Franc / Euro	-1.8
Euro / Yen	+6.7

Significant Commodities (US dollar terms) 30.04.20 - 31.07.20 (%)

Currency	Quarter Ending 31.07.20
Oil	+67.1
Gold	+14.9

ECONOMICS

In contrast to the disturbing public health and economic background, international equity markets have turned in a strong quarter so that, in a number of markets, equities are back to around the levels seen at the end of 2019. For many observers and investors, this is perplexing since such a recovery as has occurred since 23rd March seems perverse against such an unpromising background.

With the course of the pandemic so hard to plot, economic forecasts are, more than ever, difficult to make and the margin of error must therefore be expected to be large but we can look at two recent projections from the IMF and OECD to obtain some idea of the damage which has been caused to the world economy by the pandemic.

In its June 2020 World Economic Review, the IMF suggests that the global economic contraction this year will be 4.9% which was 1.9% worse than its April projection. Severe recessions like this bring serious human problems in the form of unemployment and economic hardship for many and, on the economic front, much increased levels of government and corporate borrowing with the consequences which follow from that. In June, the IMF forecast that the world economy would recover by 5.4% in 2021 but it said that this would still leave growth 6.5% below the level it forecast last January. It expects the effect of the pandemic to be greater for developed than emerging markets and developing economies, the difference being shown by its forecast of an economic contraction this year in Advanced Economies of 5.9% against one of 3.0% in Emerging Markets and Developing Economies. Within the Advanced Economies, it sees the eurozone and UK being particularly badly affected, the USA and Japan less so. But these differences are all relative as they all reflect a very significant recession. One individual country to single out within the eurozone is Italy where the IMF forecasts an economic contraction this year of 12.8%, very serious for such a heavily indebted country. Conversely for 2021, the IMF sees those economies like those of the eurozone and the UK recovering more quickly but by far less than the level of economic contraction this year. At this stage, 2021seems a very long way away in economic terms. So the margin for error must be very great given the level of uncertainty about the course of the pandemic.

Looking at Emerging Markets and Developing Economies, within an economic contraction of 3.0% this year, it sees China growing by 1.0% but poor outcomes for India (-4.5%), Russia (-6.6%), Brazil (-9.1%) and Mexico (-10.5%). With a recovery of 5.9% projected for next year, the IMF is forecasting the strongest growth in China (+8.2%) then India (+6.0%), Russia (+4.1%), Brazil (+3.6%) and Mexico (+3.3%). Again, this is such a long way away that projections must be subject to a large margin of error. Letters of the alphabet have come to signify the potential shape of the economic recovery when it comes. The optimistic forecast is a “V” where the world economy bounces back quickly, a “U” where it takes time for the recovery to occur and an “L” where it flatlines at the trough, this being the most pessimistic forecast. There are then variations like a “W” which means that, after a sharp “V” shaped recovery, the economy then has a relapse before recovering again.

In its latest economic outlook, the OECD takes two scenarios, a single hit from Covid-19 or a double hit if it returns in a second wave. The OECD projects that a single hit would cause the world economy to contract by 6.0% this year and by 7.6% if there were to be a double hit. Breaking down its forecasts, it sees the USA contracting by 7.3% with a single hit this year and 8.4% with a double hit. It sees the eurozone coming off worse than the USA, with respective economic contractions of 9.1% and 11.5%. Japan’s figures for the two scenarios are 6.1% and 7.3%. In the UK, the figures projected are 11.5% and 14.0%. As with the IMF, the OECD sees Emerging Markets and Developing Economies performing less badly. In a single hit scenario, it sees the Chinese economy contracting by 2.6% this year and in a double hit scenario by 3.7%. For India, the respective figures are 3.7% and 7.3%. The figures do, of course, vary between the two organisations but, in a sense, that is not the issue, rather it is the magnitude of the economic damage shown by all of these projections. They do, of course, expect a recovery next year but the loss of economic output and wealth is vast and the cost almost unimaginable.

Ever since the pandemic gained a grip, we have been emphasising in our reviews, starting with our special investment memorandum in early March, that investors should look ahead at trends rather than at the immediate situation. Back in March, the position looked catastrophic and shares were marked down savagely. Because the pandemic came upon us so quickly, markets did not have time to anticipate the event and its consequences. But even then, those investors who were not forced sellers, could usefully have been looking ahead as markets do. Remembering it is about trends and not what is necessarily happening at the moment, the two key factors to consider were, and still are, that, at some stage, the news on Covid-19 will become less bad and that central banks and governments would do whatever they could to stabilise the position. The news did not have to be good, just less bad, perhaps because the number of new cases was being contained and perhaps because there was encouraging news on vaccines. Indirectly, either or both of these events could help to stabilise the world economy, albeit at a lower level of activity.

In practice, this is what has happened since April as many markets have made up a lot of ground they lost during that brutal sell off in late February and early March. The search for a vaccine goes on with some early promise, but it is no more than this at this stage. Any good news on this front would please investors because it would give a hope that the pandemic can at least be tamed. If that happens, economic activity would be likely to respond positively. News on a potential vaccine has driven up share prices on certain days, but there remains a lot of work to be done and there is no certainty of success. News, good or bad, is likely to exert an influence on day to day prices.

However, the bigger driver of stock market recovery remains monetary and fiscal action, which has been on an unprecedented scale. We have written about this ever since the pandemic became a market issue and it bears repeating, even though the story is the same since it has been central to markets' revival since late March. Central banks have been printing money on an unimaginable scale since the crisis begun and this has been used to purchase assets, mainly government and corporate bonds issued to finance the consequences of the crisis for governments' expenditures and for companies' survival. Since the beginning of the year, the US Federal Reserve's balance sheet has expanded by approximately 75%, that of the ECB by approximately 40% and that of the Bank of Japan's by approximately 20%. Together, their total assets exceed US$20 trillion. The important conclusion it was important to take during those very difficult days in late February and early March was that the unprecedented levels of quantitative easing and fiscal intervention would leak into certain asset prices, one of which was equities and, another, gold, as we now know. This is what happened in the Global Financial Crisis in 2008. After hitting a low point in March 2008, share prices started their long ascent, funded by cheap and plentiful money. Whilst the cause of the recession is clearly quite different now, the measures taken bear an important resemblance in terms of monetary policy and their effects on markets, at least for now.

International equities may have a setback, of course, and many people think that they will because they can't see how the world stock market, as measured by a global index, can be roughly where it was at the start of the year, yet the corporate earnings and dividend outlook has deteriorated so sharply as a result of the pandemic. If the pessimists are right, it will be because markets will reflect the immediacy of the damage to many companies' profit and loss accounts, balance sheets and dividend actions which are not reflected in shares' ratings. If they are wrong, and we are in this camp, it will be because they have not factored into their thinking, the extreme monetary and fiscal actions taken by central banks and governments around the world to stabilise their economies. To be clear, this will not stop companies reporting dreadful results and we see evidence of this every day, rather it is to enable companies to survive and prepare for better times and a resumption of something like normal business. Unfortunately, many companies may not survive and unemployment will increase as furlough schemes and similar come to an end, but the corollary of this is that some companies will emerge stronger. That is the argument for investors to look ahead to the time when the pandemic has had much less effect and the world economy reverts to something like a normal position. The immediate issue which is influencing those, like ourselves, who are on the more positive side of the argument is not that we are optimistic about short term economic prospects, we cannot be, but that we see the effect of these extreme policy measures on asset prices. Furthermore, we do not see this as a good quality reason for considering that equities are the best asset class, so, whilst the theory may not look good, the practical effects on the stock market have been. Looked at in grossly oversimplified terms, it is a question of vast amounts of newly created money chasing a finite amount of assets, in this case shares, with the result that asset prices are driven higher. In this respect, we need to compare the position of shares and fixed interest securities.

At the time of writing, there is approximately US$16 trillion of debt standing on negative yields. The main reason for this is central bank policy where individual central banks administer yields directly through setting short term interest rates or through yield control where they exercise it through their activities in the bond markets. As we saw earlier in this review, central bank balance sheets have ballooned in size since the beginning of the year as they have purchased assets. However, the suppression of interest rates means that there is no market signalling from the fixed interest sector. In normal circumstances, huge borrowing demands would mean higher interest rates. Some investors are therefore comfortable to buy at current yield levels, even negative ones, perhaps because they are so nervous about the investment background that they are prepared to pay to lend to a creditworthy borrower. But we have to ask the question, how can very small positive yields or negative ones possibly be anything other than a bad investment over anything other than the short term for an investor who does not have to hold fixed interest securities? Many investors require income from their portfolios and fixed interest securities and cash are not really providing that. Even after dividend cuts and omissions, the yield on most equity markets is higher than on high quality bonds. If we assume, as is almost certainly the case, that central banks are likely to maintain interest rates at around current levels, then equities are more attractive. At some stage, interest rates will start to rise. Why will this happen? Firstly, central banks cannot continue to expand their balance sheets indefinitely. They risk losses if they have to sell assets below their purchase costs and, from a macroeconomic point of view, there is the inflationary risk. If the clearing banks' balances start to circulate more quickly with the velocity of circulation increasing, rising demand in the economy could lead to an inflationary spiral. Central banks are likely to raise interest rates in those circumstances to try to dampen demand and inflation. Then there is the volume of government bond issuance. At the moment, central banks are hoovering up government bonds in the secondary market but, as stated above, this cannot continue indefinitely. Even when world economies revert to a more normal position, the legacy of the enormous debt issuance will continue since budget deficits, even if declining, will still come in much larger than before the pandemic. Linked with central banks being more cautious about buying government debt, the still large budget deficits and the very large bond issues argue for higher interest rates later on. Given the extreme level of interest rates at present, any reversion towards the mean in fixed interest yields will mean significant weakness in prices with those at the longest maturity spectrum particularly vulnerable. Investors risk significant losses in the fixed interest market that they may never be able to make up. Therein lies the contrast with equities. Even if they were to have a significant setback, as they did say in the dot.com bubble burst or the Global Financial Crisis, they are likely to recover and move ahead after a while. Put another way, one asset class is almost certainly very seriously overvalued and due for a major setback at some stage, whereas the other, even if it is overvalued as some say, is nowhere near that position.

When we look back at the end of our 2019 review, the issues we highlighted were the USA/China trade dispute, the uncertainty about how long China would tolerate the unrest in Hong Kong and the US Presidential election in November. We also indicated a high degree of confidence about the persistence of very easy monetary policy. Of course, we now have the utmost confidence that this will remain the case but, at the time, we did not know about Covid-19. Whilst Covid-19 has naturally dominated the headlines, if there is a close second, it would be the dramatic worsening of US/China relations, but also the relations between China and many other countries as a reaction to its activities in Hong Kong and territorial expansion elsewhere, notably in the South China Sea and on the Indian border and its increasingly aggressive approach to Taiwan. The lack of trust in China has led to action against Huawei leading to counter threats from China and a full out trade war could be on the horizon. At the time we were writing, about the turn of the year, there was some hope that there could be a rapprochement, although we had much less certainty about this than about the continuation of very easy monetary policy. Now it feels that there is almost no chance as the blame game ratchets up over the origin of Covid-19 and the approach of the US election means that China becomes a political play for the politicians. We have written many times about the dangers of protectionism but, for the moment, it takes second place to Covid-19. However, there has developed a connection between the two. Many manufacturing companies rely on international supply chains and "just in time" ordering to minimise stocks and therefore working capital requirements, but Covid-19 showed the fragility of the supply chain in these unexpected circumstances and led to the disruption of final manufacturing. This event, plus increasing protectionism which we have witnessed, has come together to provide a negative economic result, offset to some extent by the prospect of more supply chain security. So, it will come down to the trade off between reshoring some production and lost efficiency from not choosing the cheapest source of supply, offset to some extent by more security of supply and therefore less interruption to final production, as has occurred during the pandemic. We might expect to see more economic nationalism and moves to create national champions, perhaps particularly in Europe. But however this trend develops, the direction is clear and is likely to lead to lower growth than would otherwise have occurred before the acrimonious dispute between the USA and China and the Covid-19 pandemic.

Coming out of the economic crisis caused by the pandemic may prove to be more difficult than the lockdown measures taken earlier in the year to limit the spread of the pandemic. Because there is still so much uncertainty about the course of the pandemic and whether any effective vaccines will become available, it makes decision making very difficult for governments and central banks. Governments, in particular, have to weigh the trade off between public health and the economic damage caused and it is a highly unenviable decision. Governments have to try to restore economic growth since borrowing such large sums, as is being done this year, is not an acceptable economic risk because it will effectively be seen as monetising debt which occurs when central banks directly fund governments by creating money. At present, except in countries with deeply flawed economies, this is not done but, where it is, in countries like Venezuela and Zimbabwe, all confidence in a currency is lost and very high levels of inflation or hyperinflation exist. At present, there is a fine distinction between the type of quantitative easing being practised by most major central banks and direct financing of government expenditure. At the moment, government debt is being purchased in the secondary market but buyers in the primary market know there is a buyer behind them in the form of the relevant central bank. Most, but not all, economists believe that, beyond a certain debt level for a country, economic growth prospects are compromised as the debt servicing levels bear down on governments' budgets because of rising interest payments. In normal circumstances, governments would take action to control their worsening budget deficits through fiscal measures but, with unemployment set to rise significantly as a result of the economic crisis, restrictive budgets would aggravate the situation. So, it has to be a balance between controlling the level of expenditure necessitated by the pandemic to support industry and businesses and the need to limit the time when these support measures continue to be in operation at current levels. We can be as certain as it is possible to be that monetary policy will remain extremely loose, both in terms of interest rates and quantitative easing and, in the short term, fiscal policy will be very supportive.

So, what does this outlook mean for investors? Current economic policy, whether monetary or fiscal, is at a level so extreme that, at the beginning of this year, would have been unimaginable. It is clearly high risk, but inevitable given what has happened. In the worst case, and there is some evidence of what some investors are thinking judging by the gold price, the explosion in the size of central banks' balance sheets, resulting from assets being acquired as a result of quantitative easing, could lead to a surge in inflation. If that were to happen, conventional fixed interest securities, given their current unrealistic yields, would be highly vulnerable to a serious loss of value, whilst, as happens in countries suffering from hyperinflation, equities do well in nominal times as shares are seen as a hedge against inflation. Even at much milder levels of inflation, which we may see in due course, the outcome could be the same, even if less marked. Of course, this may seem a long way off at present, with a number of central banks concerned about not meeting their inflation targets, but one cannot count on inflation remaining so low. Cash would also be a victim in terms of real returns in an inflationary environment.

Politics as well as economics are important drivers of markets. In this respect, the forthcoming US Presidential and Congressional elections could be important for investors. At present, Joe Biden is favourite to win in November and it is possible that the Democrats will gain control of the Senate, in which case they would not only hold the White House but also both houses of Congress. The Democrats have moved leftwards and, with anti business sentiment quite strong with some large technology companies in their sights for example, it could be more difficult for the US market, although the monetary drivers of markets will still be important. With large bills everywhere to be settled for the financial support given to individuals and companies, it seems inevitable that the corporate sector will be expected to pick up at least part of the tab. Some commentators and politicians have been critical of companies paying dividends during the crisis, seemingly unaware of how important they are to many people and how many people are affected through the holdings of equities in pension funds. This is another example of anti business and anti investor sentiment which ignores the vital role which dividends have in the savings market.

Whilst many stock markets, but, strikingly, not that of the UK, have recovered strongly since the end of March and, we believe, for the reasons given in this and previous reviews, that equities remain the preferred asset, there is absolutely no reason for complacency, so difficult are the economic and political conditions. We are long term investors and see clear advantages of equities over bonds and cash but, after such a strong recovery, we must expect more periods of turbulence. As the underperformance of the UK market shows, geographical diversification remains of paramount importance.