meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

The negative returns in bond and equity markets over the last quarter reflect the serious geopolitical and economic environment in which the world finds itself. There has not really been any hiding place for investors, although sterling based investors with unhedged overseas exposure have seen the declines in the value of their holdings mitigated by the fall in sterling. Even some commodity prices which have contributed to the elevated inflation levels we now see have pulled back in price.

The tables below detail relevant movements in markets :

International Equities 31.03.22 - 30.06.22

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-10.7	-11.3	-18.2	-12.9
Finland	-6.3	-4.6	-12.0	-6.3
France	-8.8	-7.1	-14.3	-8.8
Germany	-12.4	-10.7	-17.7	-12.4
Hong Kong, China	-1.5	+6.6	-1.7	+4.6
Italy	-12.0	-10.4	-17.3	-12.0
Japan	-3.7	-6.8	-14.0	-8.5
Netherlands	-14.8	-13.2	-19.9	-14.8
Spain	-2.8	-0.9	-8.6	-2.8
Switzerland	-10.7	-7.0	-14.2	-8.7
UK	-3.6	-3.6	-11.1	-5.4
USA	-16.6	-9.6	-16.6	-11.3
All World Europe ex UK	-10.4	-8.6	-15.7	-10.3
All World Asia Pacific ex Japan	-7.1	-3.2	-10.7	-5.0
All World Asia Pacific	-6.1	-4.4	-11.8	-6.1
All World Latin America	-15.0	-14.8	-21.4	-16.3
All World All Emerging Markets	-7.3	-2.6	-10.2	-4.4
All World	-13.3	-8.3	-15.4	-10.0

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -7.4%

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

Currency	31.03.22	30.06.22
Sterling	1.61	2.23
US Dollar	2.34	3.02
Yen	0.21	0.23
Germany (Euro)	0.55	1.33

Sterling's performance during the quarter ending 30.06.22 (%)

Currency	Quarter Ending 30.06.22
US Dollar	-7.5
Canadian Dollar	-4.7
Yen	+3.2
Euro	-2.2
Swiss Franc	-4.2
Australian Dollar	+0.6

Other currency movements during the quarter ending 30.06.22 (%)

Currency	Quarter Ending 30.06.22
US Dollar / Canadian Dollar	+3.1
US Dollar / Yen	+11.6
US Dollar / Euro	+5.7
Swiss Franc / Euro	+2.2
Euro / Yen	+5.6

Significant Commodities (US dollar terms) 31.03.22 - 30.06.22 (%)

Currency	Quarter Ending 30.06.22
Oil	+2.4
Gold	-6.0

MARKETS

The disturbed geopolitical and economic background has left its mark on the international securities markets in the second quarter. In local currency terms, the FTSE All World Index has shown a total return of -13.3%, in sterling terms -8.3%, in US dollar terms -15.4% and, in euro terms, -10.0%. Looking at local currency returns firstly, the USA was one of the weakest markets with the FTSE USA Index returning -16.6%. Amongst the best relative performances were the UK where the FTSE UK Index returned -3.6%, and Japan where the FTSE Japan Index returned -3.7%. Also holding up relatively well were the FTSE Asia Pacific Index which returned -6.1%, the FTSE Asia Pacific ex Japan Index which returned -7.1% and the FTSE All World All Emerging Markets Index which returned -7.3%. Returns changed quite significantly in sterling adjusted terms. On the negative side, the FTSE All World Latin America Index returned -14.8%, reversing strength seen earlier in the year. After showing relative strength in local currency terms, the FTSE Australia Index underperformed in sterling terms with the FTSE Australia Index returning -11.3%. The underperformance of the FTSE USA Index against the FTSE All World Index narrowed considerably as it returned -9.6%, just 1.3% worse than the FTSE All World Index. The FTSE All World All Emerging Markets Index, -2.6%, the FTSE Asia Pacific ex Japan Index, -3.2%, and the FTSE Asia Pacific Index, -4.4%, all continued to show relative outperformance, albeit still remaining in negative territory.

The international bond markets, too, had a difficult quarter. Taking ten year government bond yields as a benchmark, the gross redemption yield on the UK government bond rose by 62 basis points to 2.23%, on the US Treasury bond by 68 basis points to 3.02%, on the Japanese Government Bond by 2 basis points to 0.23% (the Bank of Japan operates a yield control policy) and the German Bund by 78 basis points to 1.33%.

There were significant movements in the foreign exchange markets. The only two currencies against which sterling appreciated in our table were the yen, against which sterling rose by 3.2%, and the Australian dollar, against which it rose by 0.6%, but against the US dollar it fell by 7.7%, against the Canadian dollar by 4.7%, against the Swiss Franc by 4.2% and against the euro by 2.2%. It is worth noting that the strength of the Swiss Franc against the euro meant that it achieved parity at the end of the quarter.

In the commodity markets, the quarterly movement in the oil price was much lower than we have previously seen with the oil price, as measured by Brent crude, rising by 2.4%. Gold had a disappointing quarter, probably reflecting interest rate increases and the prospect of many more to come.

ECONOMICS

The geopolitical background is shocking and the economic outlook awful. There cannot be many commentators who disagree with this statement, although this does not necessarily read across to securities prices. This may seem counterintuitive and we will come on to this later.

The most shocking event is, of course, the Russian invasion of Ukraine and the unimaginable suffering which this has caused and continues to cause. Now, over four months after the attack started, the world is in danger of getting war fatigue and of moving on to other problems. It should not do so, of course, but that is the danger as we see the collateral damage in the form of severe economic problems coming to the fore. Not surprisingly, this has rattled markets but, unpleasant as some of the declines in prices are, many would have expected them to be worse.

As this is an economic and investment review, we will inevitably be discussing economic issues, leaving the geopolitical issues to one side. That does not imply that the latter is less important than the economic issues, just that, linking our review to various economic consequences, might set out the picture better. The Russian invasion of Ukraine happened just as the UK was attempting to adapt to the new Brexit world and most countries were working out how to recover from all the disruption which Covid-19 had caused.

At the end of last year, and at other times, we were saying that a big challenge for investors in 2022 would be how equities performed in the face of rising interest rates. It was already becoming quite clear that central banks had been too slow to raise interest rates, emphasising that the rise in inflation was temporary or "transitory" as they called it. Of course, central banks are supposed to be independent and certainly not allowed to finance government spending, which had exploded in the face of Covid-19 and the measures which it had been necessary to take to keep the world's economies afloat. However, one could not help feeling that central banks and governments were closer than they perhaps should be. With the aggressive use of monetary policy in the form of Quantitative Easing (QE) and ultra low interest rates at a time when economies were recovering, the belief that supply chain difficulties caused by Covid-19 would be temporary and then that prices would fall back when the pressure was relieved seemed very optimistic at the time. Negative real interest rates, such as we have witnessed for a long time, were always likely to lead to a rise in inflation when activity increased and the banks' reserves started to circulate more quickly as confidence recovered. No one was to know that Russia would invade Ukraine and would make some supply difficulties even more critical in many cases, resulting in sharply increasing prices, but the scene was set last year when central banks missed recognising that the rise in inflation was not transitory. This is not being said with the benefit of hindsight. Many economists felt the same at the time.

Now, we have a situation where inflation has completely got away from the central banks' power to control it with normal degrees of tightening. The clear danger is that they will have to compensate for past inaction by sharper and more frequent increases in interest rates, which risk bringing economies to a juddering stop and perhaps reverse. It can perhaps be looked back on as a time when central banks made some of their most serious policy mistakes. At the time of writing, inflation (year on year) in the USA is running at 8.6%, in the UK at 9.1% and in the euro area at 8.1%. Energy has a lot to do with this but there is no guarantee that prices will fall back, especially with the sanctions on Russia. Economists worry about people's inflation expectations, believing that these may be more important than the actual level. If current high inflation levels inform people's expectations of pay increases, then these high inflation rates are in danger of becoming embedded in the system. We can already see this in terms of pay claims and threats of industrial action.

The fact that central banks are so far "behind the curve" on interest rates, increases the chance of a recession. We have most recently seen the Federal Reserve raise interest rates by 0.75%, a particularly large increase, and there may be more of the same magnitude. Many individuals and businesses have been used to servicing their debt at very low interest rates so, even if they have become more indebted, the servicing costs have been manageable. In normal circumstances, with inflation at the levels shown above, interest rates would be expected to be at a multiple of current levels, which would cause severe distress for many corporate and personal borrowers and affect economic activity. In the housing market, this negative development is mitigated to some extent by the fact that many borrowers fixed their mortgages at the low rates then prevailing, so it will be some time before the full effects are felt, but the potential switch from fixed to floating or newly fixed rates could be very large. Governments will also begin to feel the squeeze. During the pandemic, governments' budget deficits ballooned in size, together with overall debt levels in relationship to GDP. Again, it will take time for the full significance of interest rate increases to come through because many governments issued debt on very favourable terms, but, with budget deficits still large, economic growth may not be sufficient to keep overall borrowing levels from rising. Whilst this will be a problem in many countries, it has a particular relevance for the eurozone, which contains countries with very different credit risks. Germany is, of course, the strongest credit but the third largest eurozone member, Italy, has an outstanding public debt to GDP ratio of around 155%, compared to Germany's 69%. Even the second largest eurozone member, France, has a very large number against its name, at 116%, whilst the fourth largest, Spain, is around 122%. These different levels of outstanding public debt in relation to GDP are reflected in the interest rates which the various eurozone members have to pay on their debt, so, for example, Italy and Spain, particularly the former, pay much more to borrow than Germany. Whilst the spreads have narrowed in recent days on ten year government debt, Italy pays about 188 basis points more on its debt than Germany and it was, recently, as high as 230 basis points. This creates a problem for the European Central Bank because, with a single currency and a "one size fits all" monetary policy, the effect of a loss of confidence in one member cannot be isolated as it could be when the eurozone country in question ran its own monetary policy. The spreads between Italian (but it could be other eurozone members which are highly indebted) and German bonds clearly concerned the ECB who, at a special meeting, decided to try to develop a new tool to address the problem of widening interest rate spreads between its members. It will be recalled that monetary union was meant to lead to convergence amongst its members, whereas the opposite has happened, hence the current problems. By supporting the bond markets of weaker eurozone members, if that is what the ECB does in some form, it threatens to distort the bond market badly and it runs the threat of the German Constitutional Court ruling that this is the effective monetary financing of government debt, which is illegal. When the full bond buying programme was in force, credit risks in the eurozone (and elsewhere) were not in the forefront of investors' minds. Now, as monetary policy tightens, they are. When QE was in full flow and interest rates were either side of zero, many investors were unconcerned about credit risk because of the absence of price signalling in the market. Price signalling is still highly imperfect because interest rates are artificially low and QE has not ended everywhere, but it is, nevertheless, less imperfect than it was, so that credit risks are less mispriced. It will be interesting to see what the ECB comes up with in respect of dealing with elevated spreads within the eurozone but, whatever it is, it will surely continue to be a market distorting factor.

Related to this, is the effect on emerging market debt. With the Federal Reserve now seemingly following a more aggressive stance on monetary policy, it has quite rationally resulted in the US dollar's trade weighted index rising. A strong US dollar is not good news for emerging markets, with a large amount of US dollar debt outstanding. It raises the risk of these economies having to raise interest rates to support their currencies. It increases their financial vulnerability. The collapse of the Sri Lankan economy could be the canary in the mine and further defaults on emerging market debt look almost inevitable. This would mean complicated restructurings and one area of interest is what view China would take, given that it is a large creditor of many developing countries.

But to come back to the original dilemma for central banks in the context of what most economists believe to have been a fundamental policy mistake last year when they delayed tightening monetary policy, is the belief, according to the central banks, that inflation was transitory. If they put the taming of inflation before economic growth and tighten monetary policy sharply through regular and quite large interest rate increases and quantitative tightening (QT), the chances of a recession will be quite high. The effect on countries' budget deficits would be to make a bad situation worse as tax revenues are adversely affected and spending might also have to rise, for example, to meet the extra costs of higher unemployment. Only when inflation has been brought back to target levels, i.e. much lower than now, will central banks be able to start loosening monetary policy to a level where it is supportive of renewed economic growth. The economic cost will likely be higher unemployment, output lost forever and worsening public finances, with elevated credit risks for some countries' debt. On the other hand, taking a risk with monetary policy and not tightening policy fast enough and therefore risking the continuation of high inflation is probably more unappetising than the first. Inflationary expectations will become embedded in pay claims, which, if granted, will keep inflation high. Whilst high inflation is not necessarily bad news for borrowers as the real value of their liabilities falls, it has a devasting effect on savers. It can undermine the competitiveness of countries with above average inflation and would be likely to be accompanied by relative currency weakness. But we come back to the particular risks that we mentioned earlier to the eurozone, because it is a currency union, and to developing countries, which are quite likely to see their foreign liabilities increase where, say, the

US dollar rises against their own currencies. Where this affects countries with weak finances, so it also threatens companies with sub investment grade credit ratings in the junk bond market. For the eurozone, this is perhaps its biggest test yet because it could involve not just the manipulation of absolute interest rates levels through QE, and soon quantitative tightening (QT), but also relative interest rates between the various eurozone members; in other words, trying to manage the spread between, say, Italian and German bonds, which is surely not the job of the ECB. If whatever plan the ECB comes up with for addressing this does not work, and markets will surely test it, this will be a major problem for the credibility of the eurozone. Given the devastating effects of the Covid-19 crisis, it was inevitable that central banks would have to lower interest rates to extreme levels to keep debt servicing costs manageable and to keep businesses, which faced financial difficulty, afloat. However, there was always going to be a cost later on when interest rates started to move towards more normal levels and servicing the debt becomes more onerous and cash flows insufficient to service the interest payments. We are moving towards this position now and the rate of change could become quite challenging.

The investment conclusions we draw from this as far as fixed interest securities are concerned are the same as for many months. The fixed interest market remains deeply unattractive and the risks high. If we look at the table of ten year government bond yields at the beginning of this review and relate them to current inflation levels, the returns are highly negative in inflation adjusted terms. As QE is ended and QT starts, the supply of fixed interest securities to the market is going to increase, putting more pressure on prices and all the time governments are still having to borrow money to cover their budget deficits. At the high grade end of the market, where one would not expect defaults, the risk is related to the negative price potential arising from quite inappropriately low yields. At the lower grade end of the market, at junk bond level, the risk is not only inappropriate pricing but also default risk arising from the very poor economic background and its effect on companies' trading. In the eurozone, there is specific risk arising from whatever policy tool the ECB decides to employ to deal with increasing spreads against German government bonds not working and the market testing the ECB's resolve. Far from converging, eurozone bond markets are diverging and this was not meant to happen when the euro was created. Eurozone economies are diverging for many reasons, such as different debt levels, productivity levels and unemployment rates, industry mix and the cost of doing business, to name some reasons. In our view, only when we see inflation coming down to very low levels such as pre-Covid, will current yields look interesting. If inflation does prove to have become embedded in the system, as looks quite possible at this stage, then current fixed interest yields look significantly mispriced. We remain very negative on the fixed interest market.

One area of that market which is worth specific comment is the Japanese Government Bond market. As we can see from the table of ten year government bond yields at the beginning of this review, the movement in JGB yields is minor compared to other countries' bonds. This is because of the Bank of Japan's idiosyncratic monetary policy whereby it is trying to operate a policy of yield curve control. The Bank of Japan has again confirmed its policy of buying as much government debt as it takes to keep ten year government bond yields below 0.25%. There are obvious implications for the central bank's balance sheet with an open ended commitment, but also for the exchange rate. For a long time, the yen has been a notably weak currency. A popular trade has been to short the yen and buy the US dollar where interest rates are rising and helping to raise the value of the US dollar. For a long time, the Bank of Japan has been trying to induce some inflation into the Japanese economy and consumer prices are now in positive territory, being 2.4% higher, year on year. Japanese business is now complaining about its imported input costs, so some economists are now wondering if the policy is now near the end of its useful life. If the Bank of Japan were to scrap its yield curve control policy, it could cause quite a sell off in the JGB market. The majority of Japanese government debt is held internally, but a sharp fall in the JGB market could have implications globally for bond markets. For now, the message from the Bank of Japan is clear but if, as is likely, bond yields in other markets continue to rise and the gap in yields between JGBs and those in other bond markets widens, it is highly likely that the yen will continue to weaken. One would expect such a development to put pressure on the Bank of Japan to review its long standing policy, although there is no sign of it yet.

In normal circumstances, cash may be seen as an alternative to bonds. In the past, before monetary policy took on its extreme form after the Global Financial Crisis, cash would have seemed a sensible short term repository for many whilst awaiting a suitable entry point for the fixed interest or equity markets. In those days, the relationship between interest rates and inflation would normally mean that a depositor was not losing out in real terms, unlike now when, even after current minuscule rises interest rates, a deposit is losing its value quite rapidly in real inflation adjusted returns. Now, it is much more difficult to consider cash as a realistic asset class for anything other than the very short term. For the avoidance of doubt, this does not mean modest percentages of a portfolio held in cash for foreseeable working needs or, if a portfolio is more or less fully invested, for opportunistic purchases of securities at lower prices. We are talking about cash as a main asset class in its own right. In current circumstances, a mandate to hold cash as a main asset class would have to include an acceptance that a decline in the real value of a portfolio was likely and acceptable because of the extreme risk aversion attitude of the investor. There will not be many mandates like that. So, apart for the reasons for holding cash mentioned above, and in those particular circumstances, we do not regard it as a potentially attractive asset in current circumstances.

For some, gold is a favoured asset, with one of its historical rationales being that it is a store of value in troubled times, either economically or politically, and can be an acceptable medium of exchange. One can certainly say that these are troubled times and that current levels of inflation could make the metal an attractive store of value. However, it hasn't performed well in these very difficult times. One of its drawbacks is, of course, that it doesn't produce any income and, although with current very low interest rates the opportunity cost is very low, they are going to rise, so investors may be considering that. As our table shows, in this most difficult quarter it has lost 6% of its value.

Before moving on to discuss the rationale for holding shares in the current environment, we should note some of the excesses that have been spawned by this long period of ultra loose monetary policy and one such is cryptocurrencies. Regulators have warned about these, pointing out that they could go to nothing, and it is one of the mysteries of the time why these have taken off so significantly. The volatility is enormous and recent entrants have probably already lost substantial sums. They are pure speculation and represent the excesses of recent times. Unfortunately, a lot of money is invested in cryptocurrencies and a lot of investors will have experienced severe wealth destruction with the recent collapse in prices. Whilst the consequences are uncertain, they could be significant.

Property is, of course, another asset and this can be accessed through shares so we will include them in our discussion of the equity markets. On the face of it, current times would not seem to be ones in which shares would flourish and this quarter's performance would seem to bear that out. Given that, up to the end of last year, equities had been performing well, the setback this year has been more modest than one might have expected and, in no sense, represents a panic reaction to the unexpected events.

Firstly, let us look at the negative argument for equities at present and it is not hard to construct one. The world economy is slowing down and it could go into a recession as a result of a significant tightening of monetary policy which is necessary to curb inflation which has risen way beyond central banks' target levels. This will most likely either reduce the rate of increase of corporate profits or cause them to fall. The theory (and the recent practice) is that this will affect growth companies shares more, especially in the technology sector, where corporate earnings, well out in the future, will have to reflect a rising discount rate as a result of rising interest rates and therefore reduce the net present value of the company. In other words, this will be the opposite of what we saw when interest rates were at rock bottom. This would be the standard case against equities in a rising interest rate environment, other than in the early stages when rising interest rates could be as a result of central banks tightening monetary policy in the face of economic strength and therefore buoyant corporate profits. This is not the case here.

In the past, the present combination of very high inflation and ultra low interest rates would not have been considered a likely combination at all. Interest rates would have been much higher, quite probably above the rate of inflation. That being the case, an alternative to equities would have been raising liquidity levels by holding cash which would have been earning an acceptable rate of interest and ready to come back into the market at what would have been hoped to be lower levels. There was a risk that equities might have moved ahead before the liquidity was used but, at least, there was some compensation in terms of an interest rate competitive against inflation, which is not the case now. In current circumstances, the deeply negative real returns on cash deposits enhances the relative attraction of shares, which, in many countries, offer a higher yield than cash. Knowing that one is certainly going to lose money in real terms on cash deposits makes it easier to buy or hold shares in the knowledge that history suggests that, at some stage, shares will move up again.

However, companies are facing multiple challenges at present and this will be reflected in their revenue and profits. The supply chain is still seriously disrupted by Covid. The lockdown in large parts of China in recent months has aggravated an already difficult position. This has two consequences, firstly in terms of lost business as output is constrained by a shortage of components. This will affect revenue and profits. Secondly, companies are experiencing significant cost increases on their inputs. Some, such as certain of the consumer staples companies, seem to be able to pass on cost increases but others are having more difficulty. It is likely that experiences will differ even within sectors. There may be geographical differences. For example, companies in the USA with significant overseas business are experiencing headwinds as a result of the strength of the US dollar. Companies in some European countries, with Germany coming to mind, may face significant difficulties because of the energy crisis. Germany recorded the first foreign trade deficit in May since 1991. Companies in countries with significant currency weakness, whilst they may benefit from the translation of overseas earnings back into their local currency, may be suffering from already inflated input costs being magnified by currency weakness. Larger companies, wherever they may be located, may be better able to weather the difficult economic environment than smaller companies, perhaps because they may have more flexibility. Then the composition of the stock markets of different countries might be relevant in current circumstances. The UK market, which has been an underperformer so often in the past, has notably outperformed so far this year. This is a function of having a bias to previously unfashionable sectors like energy and mining rather than technology stocks which have propelled markets like that of the USA. In a world of rising interest rates, for the reasons mentioned earlier in this review, the maths do not look so good for stocks whose promise lies much more in the future whilst, for those companies with solid earnings and a decent dividend yield, the threat of rising interest rates can be absorbed more easily into the share price.

In our year end review, we set out what we thought would be the challenge for equity markets in 2022, the main one being how shares would respond to the threat of rising interest rates and inflation. Of course, at that time, a Russian attack on Ukraine was not foreseen. Whilst the main concern about that is the horrendous suffering which the invasion has caused and continues to cause, it has magnified what was also becoming a problem, namely the central banks' loss of control over inflation by being too complacent about "transitory" inflation, which has proved to be nothing of the sort. Together with the additional inflation arising from the Russian attack on Ukraine, this has created the perfect storm in which the world now finds itself. The central banks have to choose between trying to get on top of the inflation problem by raising interest rates faster and further than they would have wished to, or reacting to the economic showdown caused by the high level of inflation as it affects consumers' spending by moderating their tightening of monetary policy but, in so doing, risking a worsening inflation problem. The evidence at present is that they are going for the former option with all forecasts now suggesting that inflation in most countries is going to rise well above target ranges, for example, over 10% in the UK by the end of this year.

Formulating an investment policy to deal with this unique combination of unwanted events presents a challenge. Our approach has been to discard assets that we consider to be definitely unattractive, which means fixed interest securities where the yields do not reflect the reality of the inflation situation and have further to rise and therefore for prices to fall. Cash as an investment and therefore a significant percentage of a portfolio as opposed to holding modest liquidity levels for working needs, or to make opportunistic investments, is certain to lose money in real terms, even with interest rates rising and, as long term investors, this does not appeal to us.

The fall back in equities does give some value and, as we saw after the Global Financial Crisis (GFC) fourteen years ago and the start of the Covid-19 pandemic nearly two and a half years ago when markets fell sharply, they recovered strongly and, for long term investors, as our clients are, the prospect remains of equities continuing to be the best asset class. The absence of attractive alternatives enhance their value in relative terms. Our policy of investing internationally to ensure proper diversification remains unchanged. With so much bad geopolitical and economic news around we are bound to see continued heightened volatility, with markets moving on a day to day basis in response to the latest news. That seems inevitable, but long term investors should stay the course as, being too liquid when markets recover, represents an opportunity cost which may not be recovered.