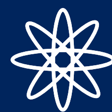
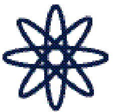


meridian

ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

International equities have performed strongly in the first quarter as a result of continued very easy monetary policy and the lack of unexpected bad news on top of what investors already know. Apart from Japanese government bond yields, which fell sharply as a result of the new and very aggressive monetary policy to be followed, there was little change overall in the gross redemption yields of high quality ten year government bonds. There were big moves in currency markets with the yen, in particular, but also sterling, being weak. In commodities, oil and gold were little changed.

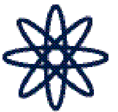
The tables below detail relevant movements in markets :

International Equities 31.12.12 - 28.03.13

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US $**	**€**
Australia	+8.6	+16.7	+9.0	+11.9
Finland	+7.1	+11.6	+4.3	+7.1
France	+3.6	+8.0	+0.9	+3.6
Germany	+2.8	+7.2	+0.1	+2.8
Hong Kong, China	+3.1	+10.2	+2.9	+5.7
Italy	-7.1	-3.1	-9.5	-7.1
Japan	+21.3	+19.4	+11.6	+11.6
Netherlands	+3.2	+7.6	+0.5	+3.2
Spain	-2.7	+1.4	-5.3	-2.7
Switzerland	+15.6	+19.6	+11.7	+14.7
UK	+9.9	+9.9	+2.7	+5.4
USA	+10.7	+18.5	+10.7	+13.7
Europe ex UK	+5.5	+10.0	+2.7	+5.5
Asia Pacific ex Japan	+3.7	+9.8	+2.6	+5.4
Asia Pacific	+10.5	+13.7	+6.3	+9.1
Latin America	-1.6	+7.5	+0.4	+3.1
All World All Emerging	-1.0	+5.2	-1.7	+0.9
The World	+8.9	+14.4	+6.9	+9.8

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +0.1%



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

Currency	31.12.12	28.03.13
Sterling	1.85	1.78
US Dollar	1.76	1.85
Yen	0.79	0.52
Germany (Euro)	1.32	1.29

Sterling's performance during the quarter ending 28.03.13 (%)

Currency	Quarter Ending 28.03.13
US Dollar	-6.5
Canadian Dollar	-4.5
Yen	+1.6
Euro	-3.7
Swiss Franc	-3.0
Australian dollar	-6.8

Other currency movements during the quarter ending 28.03.13 (%)

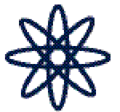
Currency	Quarter Ending 28.03.13
US Dollar/Canadian Dollar	+2.2
US Dollar/Yen	+8.6
US Dollar/Euro	+2.9
Swiss Franc/Euro	-0.8
Euro/Yen	+5.5

Significant Commodities (US dollar terms) 31.12.12 - 28.03.13 (%)

Currency	Quarter Ending 28.03.13
Oil	-1.0
Gold	-3.5

Markets

The first quarter of 2013 has witnessed an unusually strong performance from international equity markets. The total return on the FTSE World Index in local currency terms was +8.9%, in sterling terms +14.4%, in US dollar terms +6.9% and in euro terms +9.8%. If we look at local currency returns first, we note a very strong performance from Japan, +21.3%, and a notably strong performance from Switzerland, +15.6%, which contrasted with a below average performance, +5.6%, from the FTSE Europe ex UK Index. The UK and USA performed slightly above average, with the FTSE UK Index returning +9.9% and the FTSE USA Index returning +10.7%. Underperforming areas were Latin America, where the FTSE Latin American Index fell by 1.6%, and emerging markets, where the FTSE All World All Emerging Markets Index fell by 1.0%. However, looking at currency adjusted data, a different positive emerges. For sterling investors, Japan still emerges very well, with the sterling adjusted FTSE Japanese index returning +19.4%. The return on the FTSE USA Index was a spectacular +18.6% as a result of the US dollar's strength, and Australia, too, performed excellently, with the sterling adjusted



FTSE Australia Index returning +16.7%. Switzerland was also outstanding, with the FTSE Switzerland Index returning +19.6%. Currency strength against sterling also pulled up the two negative performing markets in local currency terms, Latin America and Emerging Markets, so that the relevant sterling adjusted indices returned +7.5% and +5.2% respectively.

Renewed eurozone troubles regarding Cyprus, at the end of the quarter, meant that high quality government bond yields did not vary much over the quarter, except in Japan, where the new monetary policy, which we will talk about later, drove down the ten year JGB yield 27 basis points to 0.52% over the quarter. Elsewhere, the gross redemption yield on the ten year UK government bond fell 7 basis points to 1.78%, and on ten year German Bunds by 3 basis points to 1.29%. In the USA, there was a slight uplift in yields with the ten year US Treasury bond's yield rising by 9 basis points to 1.85%.

As implied from the variations on equity returns between local currencies and sterling, there have been significant exchange rate movements, with the yen and sterling being particularly weak. Whilst sterling rose 1.6% against an even weaker yen, it fell by 6.5% against the US dollar, 4.5% against the Canadian dollar, 3.7% against the euro, 3.0% against the Swiss Franc and 6.8% against the Australian dollar.

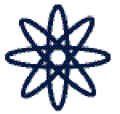
In the commodity markets, oil, as measured by Brent crude, fell by 1.0% and gold by 3.5%.

Economics

Whilst stock market trends in the first quarter might suggest a calmer economic background, any such complacency was blown apart by the eruption of the Cyprus debt crisis. Although markets have weathered this crisis quite well, the implications for investors are still significant and they should not be underestimated. Our clients will know from numerous economic reviews in the past that we believe the euro is a completely flawed currency with no proper economic and financial underpinnings and the eurozone is not an optimal currency area. Furthermore, we have felt for a long time that it will collapse under its own contradictions, either totally or partially.

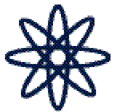
The treatment of Cyprus by the troika emphasises just how desperate those involved in the "project" have become. One might have expected that the eurozone, in particular, and the EU, in general, would seek to pull together and be mutually supportive of the euro project and the EU in a wider context, but this has not happened. We are seeing individual countries' domestic politics trumping the wider good of the eurozone and EU. If we look at the UK, we see that other EU countries are supporting efforts to diminish in size the UK's financial sector through legislation in banking and now, perhaps, fund management. In the case of Cyprus, it has largely fallen victim to German domestic politics. With an election coming later this year, the German Chancellor is having to match her opponents' anti bail out rhetoric, since these bail outs are unpopular in Germany. Mrs Merkel also faces a splintering of her support because of the emergence of an anti euro party. Against this background, Cyprus stood no chance, yet the brutality of the medicine it has had to take is still astonishing. Of course, it is important not to overdo the victim argument. Cyprus's economy was not well balanced. In relation to the size of the economy, the banks' balance sheets were far too big and, therefore, their fortunes were inextricably bound up with the sovereign. Rightly or wrongly, the country did not have a good image in the eurozone because of the size of the Russian involvement in the country and the German electorate would not stand for any favourable treatment for the country. Furthermore, by not accepting an earlier bail out offer, it made matters worse. Prior to the new President coming into office, his communist predecessor would not countenance plans that would seem fairly normal in this type of crisis, such as privatisations, for example. The delay in agreeing a bail out until after the recent election has therefore cost Cyprus dearly.

One of the most worrying aspects of the eurozone crisis since it started has been the lack of real worldliness shown by many of those making the decisions to try to deal with the economic and financial issues which have arisen in the eurozone since the sovereign debt crisis erupted in Greece. The most obvious one would have been



to admit that the creation of the euro was a major error and work round the issues (enormous ones) which would have followed on from that, basically finding a way to a return to each country having their own currency. The upheaval would have been enormous but, by continuing down the current path, they risk even worse problems in the future. Too much political capital was invested in the project for the protagonists to admit their error. That being the case, they have tried to deal with each problem as it came along, so far with a notable lack of success. But, given that we may expect no admission on this for the foreseeable future, it is the detailed comments and actions which give most cause for concern. We can pick at two examples. Firstly, there have been numerous statements that the eurozone crisis has stabilised, if not been solved, when it has been quite clear to those with more independence of mind that this is not the situation. Do those who have made these statements really believe what they say ? If they do, it is worrying because it gives no cause for optimism that the eurozone will find a way out of its impasse. The second example (and, of course, there are others) is the Cyprus bail out plan. The Greek sovereign debt haircut suffered by private investors was described as a "one off ". Now they came up with a more shocking plan, initially to expropriate the deposits not only of uninsured depositors in the relevant banks (i.e. those with deposits of over €100,000) but those of insured depositors below that limit. The Cyprus parliament rejected this proposal and now the burden will fall on uninsured depositors. However, the damage was done. It beggars belief that those involved in the original plan and even the revised plan could not see the collateral damage this will cause in terms of fears of what next they may try when the next eurozone sovereign bail out is required. The credibility of the troika, the ECB, European Commission and the IMF, has been damaged by this latest move because it moves on to territory generally considered to be taboo, i.e. expropriating depositors' money. No one will believe the protestations that Cyprus is a unique case. We now have two "unique" cases, Greece (private sector sovereign bond haircuts) and Cyprus (expropriation of depositors' money). The belief will gather ground that the next bailout will feature another "unique" loss for someone. How those responsible for the Cyprus plan cannot see the fall out from the plan is alarming. Anyone with "real world" experience would see the dangers of a systemic loss of confidence immediately. We have a further example on 21st March when the President of the Eurogroup (eurozone finance ministers) suggested that the Cyprus bail out could be a template for the future. If any statement was calculated to increase nervousness amongst depositors in eurozone banks, this would be it and there are far larger countries than Cyprus which could be affected. How could these remarks be made in such a delicate situation? He has, of course, been contradicted but the damage is done and further doubts have been sowed. As for the "ever closer/deeper Europe" so beloved of eurozone politicians when further problems arise, this is contradicted by the condemnation of the Cyprus business model by Germany and the willingness of the troika to wreck the economy of an EU and eurozone member. The sums needed to rescue a small eurozone economy were trifling compared with the three other bail out eurozone members but German domestic politics in particular determined the severity of the bail out terms. We are moving to a position within the EU where it is each country for itself. If we look at the three other bailed out members, Greece, Ireland and Portugal, not to mention Spain, with its bank assistance, we see eurozone members suffering acutely, particularly in terms of youth unemployment which has reached obscene levels partly because of the austerity measures and effective internal devaluations which have wrought such havoc on these economies.

It is necessary to spell out the latest lessons to be learned from the Cyprus bail out and the fiasco that surrounded it in the context of our investment policy. The recovery in markets in the second half of last year, after Mr. Draghi's "we will do what it takes to save the euro" speech (we have paraphrased) and the low level of volatility, suggests a certain boredom and complacency amongst investors about the eurozone story. As we have suggested in this review so far, the course of events is far from predictable, and the authorities' reaction likewise, and all of this against a deteriorating economic outlook for the eurozone. What should investors in eurozone stocks make of this ? Firstly, we should recognise that those running large eurozone based companies generally have far more real world experience than the politicians and bureaucrats. In practical terms, this means that they will try, although not always succeed, in minimising the risks to their business. Typically, and this will only partly relate

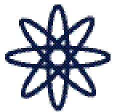


to the eurozone crisis, they will have a well diversified business, especially geographically. The weakness and problems of the eurozone might well have accelerated this process. They will also have managed their finances in ways which recognise the vulnerability of some eurozone banks and countries. Before the Cyprus crisis, we know from public statements by companies that some were sweeping up their cash from troubled eurozone countries to minimise the risks arising from a eurozone departure of a particular country. Now, given the precedent set by the expropriation of some depositors' balances in Cyprus, and the effective introduction of capital controls in that country, we might expect companies to accelerate this process to other countries they believe to be vulnerable. Thirdly, although the assurances were given at the time of the Greek bail out about the private sector's haircut on Greek sovereign debt being a one off, recent events will reinforce the scepticism of holders of eurozone bonds about assurances they have or are being given. That should make investors more wary of eurozone sovereign debt and that is even before the unattractive yields which they offer. All of these factors lead us to believe, as we have done since the eurozone began, that large good quality eurozone companies with significant geographical exposure to faster growing areas of the world represent the best way of minimising risks from the fall out from the currency area's crisis. These companies' experience of managing currency or geographical risks can be passed down to shareholders who have exposure to them. So, the lessons to be reinforced by the latest eurozone crisis are obviously to bank in the top tier of eurozone economies and banks, to avoid eurozone bonds either on grounds of valuation (high quality issues) or credit risks (the more vulnerable eurozone countries) and to stay with or invest in high quality eurozone companies for the exposure to Europe. As a matter of policy, we have favoured Swiss companies for the quality and geographical breadth of their geographical space and for not being in the eurozone which has enabled the economy to hold up well compared to most of the eurozone.

The eurozone crisis will run and run, with sticking plaster measures to treat the symptoms of its problems but not the cause, the lack of an economic underpinning for the euro. Whilst those in charge of the eurozone might ignore its inherent contradictions, one thing they may not be able to ignore is the gathering storm of political protests about the policies being inflicted on troubled eurozone countries in the name of the euro. It is not only the angry street protests in Greece and, now, Cyprus, it is also the election result in Italy which delivered an anti austerity majority and, as this is written, an electoral impasse. The anti euro and even anti EU sentiment is growing with unpredictable consequences. As we mentioned earlier, in the major creditor country, Germany, anti bail out fatigue is growing with the rise of a new eurosceptic party. This has strong academic backing and the professors understand the economies of the euro rather better than many others holding senior positions within the eurozone. Whilst markets will provide many problems for the euro, it may be disaffected electorates who get there sooner.

If this all seems to be a sorry tale of woe, it is, but, in terms of what has driven a rising equity market, we have little doubt that it is monetary policy. We make no apology for repeating what we have said many times before which is that very low interest rates and quantitative easing (money printing) will push asset prices higher. This is now a more explicit aim of the policy than when it was instituted. At the time, cheap money was promoted as a way of stabilising economies after the economic shock which arose from the 2007/8 financial crisis. Higher asset values, it is hoped, will stimulate economic activity through a positive wealth effect for businesses and individuals.

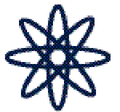
There are positive and negative consequences arising from the very loose monetary policy being followed in countries and regions like the USA, UK, eurozone and Japan. The short term positive one, we have just described above. Quantitative easing, when in place, has been operated by the relevant central banks, and has been used to suppress interest rates through the bond market with a variety of fixed interest assets being bought, mainly government bonds. The search for yield has driven bond investors to buy lower quality issues so yields have come down along the spectrum of quality whilst increasing the risks to investors as lower yields leave less of a cushion for defaults. Although there has not been the "great rotation" out of bonds into equities, at least not yet, there has been, as equity market movements might suggest, increased flows into equity funds probably from money



parked on deposit and earning hardly anything. Dividend yields in mainstream markets are higher than on ten year government bonds. As this is written, Bloomberg shows a current estimated dividend yield on the S & P 500 Index at 2.21% against a gross redemption yield of 1.85% on the ten year US Treasury at the end of the quarter. For the FTSE 100 Index the respective yields are 3.89% and 1.78% respectively, for the Euro Stoxx50 4.23% and 1.28% (ten year German Bund) and, for the Nikkei 225, 1.65% and 0.52% respectively. Furthermore, it is still reasonable to expect dividends to grow and all of these nominal dividend yields provide real yields after allowing for inflation. Against expected inflation in 2013, only the gross redemption yield on the ten year US Treasury (just) and the Japanese equivalent provide real yields. If we look at the Bloomberg estimate of the price/earnings ratio of the various markets for the current year, they do not appear expensive. In the case of the USA, the estimate is 14.1, for the UK 11.8, for the Euro Stoxx 50 11.1 and for Japan 24 (a different story). If we look at the earnings yield, the reciprocal of the price/earnings ratio, we see the earnings yields well in excess of the ten year bond yields quoted above. Those who think that stock markets are overvalued refer to the cyclically adjusted P/E ratio which recognises that current profit levels and margins are high and might revert to mean. If company profits collapse, that would happen, of course, but, whilst it is unrealistic to expect a significant rise in company profits in the foreseeable future, the international economic outlook is such that modest growth in company profits might be expected. From our perspective, even though we recognise the hugely distortive effect of recent and current monetary policy which has made bonds dangerously expensive, we think that, even after their rise, shares offer reasonable value. In a macro economic sense, there was probably no alternative to the aggressive standard and non standard monetary easing which central banks instituted in the wake of the financial crisis but, with short term interest rates so low, further quantitative easing is likely to be less effective.

So, for the stock market and borrowers, quantitative easing combined with very low interest rates has been beneficial so far and probably for the foreseeable future. However, there are significant losers, one class of which is obviously savers. Those relying on bank deposits have effectively seen this source of income almost vanish. These mostly reflect the savings of the elderly. Many of the older generation may not be natural equity investors, although any who have switched will have benefited from the rise in stock markets from March 2009's low point. Those who have bought or need to buy annuities have been seriously affected by the derisory annuity rates on offer as a result of the collapdr in government bond yields. Company pension schemes have been badly hit. Although their investments should have risen in value, the low level of government bond yields has meant a low rate at which they discount their future liabilities, meaning that companies have needed to top up their pension schemes, in many cases at the cost of productive investment. Perhaps the most negative aspect is one which is not clear at present but which looms in the future and that is the spectre of inflation. Because confidence is low at present, the extra money which has been created has not circulated round the economies in question in a meaningful way so there is still an output gap between existing production levels and productive capacity. This means that inflationary pressures have not yet arrived. In due course, if inflation is to be avoided, the newly created money will have to be withdrawn from the economies in question by central banks selling the assets, which they have acquired through quantitative easing, back to the private sector or by requiring banks to place additional reserves with them. This will be a challenge to interest rates as a large seller of bonds, at a time when governments are still borrowing, is likely to raise interest rates if the policy is reversed that way. It is something which will have to be handled very carefully. We are not there yet and markets are enjoying the "sugar rush" of cheap and newly printed money, but a hangover later on threatens. The reversal of very loose standard and non standard monetary policy is probably some way off but the implications for investors are potentially very significant. Investors need to be aware of this although it should not affect current investment policy.

Yet if investors had been to Mars for the whole of the first quarter and returned to see that international equity markets were at a higher level than at the start, they might be forgiven for thinking that world economic conditions were good and economic growth strong. Of course, they would be wrong but, equally, notwithstanding the woes of



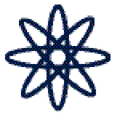
the eurozone and the UK, it would not be right to be too gloomy. Important parts of the world are doing well and there is no sign of global recession. Recession is localised mainly to troubled eurozone economies. Significantly, company earnings and dividends are still expected to rise this year. The latest IMF forecasts, published in January, suggest world economic growth of 3.5% this year, not spectacular but, at least, growth.

So, now, let us look at recent economic news from different parts of the world, starting with the USA where, despite the sequester which came into force on 1st March (obviously there will be a delay in its actual effects), the news has been moderately encouraging. Looking back to the last quarter of 2012 and, therefore, not particularly relevant to what is happening now, there was a small revision to GDP which was significant only in so far as it changed from a negative figure, -0.1%, to a positive figure, +0.1% and in, the latest estimate, +0.4%, rounding errors really. The Congressional Budget Office's assessment of the effect of the sequester is that it will knock 0.6% off growth this year and that there will be 750,000 fewer jobs by the end of 2013. This is separate to the effect of the 1st January tax rises and end of payroll holidays. Although the Republicans in the House of Representatives agreed to the tax rises, they are likely to dig in their heels with regard to spending, so the bitter battle between the parties has been merely postponed. Meanwhile, and providing some short term respite, Congress has passed legislation to fund the government fully until the end of September which should lower the political temperature a little.

Meanwhile, on the monetary front, policy remains loose and supportive to economic growth and the reduction in the unemployment rate to the Federal Reserve's target of 6.5% (currently 7.7%). In its latest statement, the FOMC confirms that asset purchases will continue at US$85 billion per month. Commentators did notice, however, that the statement was a little more nuanced than previously, perhaps reflecting some concerns within the FOMC that quantitative easing was becoming less effective, the more it is increased. The words which alerted analysts to this nuanced position were that the Fed "will continue to take appropriate account of the likely efficacy and costs of such purchases as well as the extent of progress towards its economic objectives."

As we say, most of the indicators for the USA have provided some encouragement. The closely watched Purchasing Managers Indices are both in positive territory, although the latest one for manufacturing was slightly disappointing, at 51.3 (54.2) but for services, at 56.0 (55.2). In terms of consumer sentiment, the latest Thomson Reuters University of Michigan index for March rose to 78.6 (77.6). Employment figures have generally been encouraging, although the latest non farm payrolls showing a rise of 88,000 were below expectations. The unemployment rate was 7.6% (7.7%). The housing market, where all the trouble started in 2007, is showing signs of improvement which, in turn, should give more confidence to consumers. House prices are rising, new housing starts have been recovering strongly and the National Association of Housebuilders Index has recovered strongly from the third quarter of last year and remained fairly stable at the higher levels. If we take the latest IMF forecast for the USA, it is looking at growth of 2.0% this year. This is, of course, a modest level of growth but it compares spectacularly well with the eurozone where the latest European Commission forecast is for the eurozone bloc to contract by 0.3% this year. A still more recent forecast from the ECB suggests a contraction of 0.5% this year. Whatever the final outcome for 2013, it is almost certain that the US economy will grow and that of the eurozone will contract.

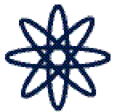
We have talked about the high level problems of the eurozone at length and what we believe to be the existential threat to the currency and all the increasingly desperate measures being taken to try to hold it together. In a sense, therefore, more detailed economic data seems of secondary importance but it is still relevant to show individual terms of data which reflect how bad the situation is in some countries. The latest Purchasing Managers Indices show the estimate for the eurozone's manufacturing sector to be 46.6 (47.9) and for services to be 46.5 (47.9). Just looking at the data for the two largest eurozone economies, Germany and France, we see that even the mighty economic powerhouse, Germany, is struggling (although from a very strong position). Its manufacturing PMI stands in negative territory, 48.9 (50.3), whilst for services, the level implies modest growth with a reading



of 51.6 (54.7). The readings for the number two economy, France, are dire. The latest manufacturing PMI reading is 43.9 (43.9) and for services 41.9 (43.7). Unemployment in the eurozone is high and rising at 11.9% in January (11.8%). Against such a background, it is unsurprising that the ECB declared that it would maintain an easy monetary policy "as long as needed". It looks like being a very long time.

All of the eurozone countries, with the possible exception of Ireland, which have been bailed out including Spain (for the banks but not the sovereign), are expected to contract this year under the weight of the austerity packages, which they are being obliged to institute under the terms of their bail out agreements. The latest EC forecasts for the most troubled eurozone countries make dismal reading and it is quite possible that these are over optimistic. Forecasts for growth in Greece were -4.4%, for Portugal -1.9%, and for Cyprus -3.5% (although subsequent events have made this forecast redundant, with the outcome going to be far worse). For Spain, with its bank bail out, the forecast was -1.4% and for Italy -1.0%. Even for Germany, the EC's forecast is for growth of just 0.5%, slightly lower than last year's 0.7%, and for France 0.1%. For Ireland, an exception, growth is forecast at 1.1%. Opposition to the austerity measures is growing all the time, as evidenced by the indecisive election result in Italy where anti austerity parties gained the most votes. It is going to be difficult to make any progress in Italy and, as the third largest member of the eurozone, failure to adhere to budget deficit rules could present a major problem for the euro. We would guess that countries like Greece (unemployment rate 27% and youth unemployment 61.7%) and Spain (26.0% and 55.1% respectively) are near the tipping point at which the electorate starts to say "no more". Within the eurozone as a whole, there is a current account surplus of around 1.2% of GDP, but this masks huge imbalances within it. Germany has a large current account surplus of around 5.3% of GDP and the Netherlands an even larger one, 8.5%. France and Italy have current account deficits, a function of their declining competitiveness under the euro. In a eurozone context, there have been loud calls for Germany to loosen its purse strings, so that extra spending would filter through to weaker eurozone countries and help to assist in rebalancing the eurozone. But, as an example of how each country follows its own interests, Germany has tabled plans to cut spending and balance its budget ahead of schedule, exactly the opposite of what is required in a eurozone context, although commendable if considered in domestic terms without any currency union obligations.

An increasing concern for the eurozone is France where forecasts for economic growth are being downgraded in the face of negative economic news which has caused the French government to abandon its plan to reduce the French budget deficit to 3% of GDP this year because it would involve too much austerity being piled upon current economic weakness. Mr Hollande says the deficit looks like being 3.7% of GDP . It must be remembered that, in the early days of the euro, France and Germany both ignored the budget deficit limits laid down by the Stability and Growth Pact because it did not suit them at the time to observe the rules. That opened the door for others to follow later on which was one cause of the present problems. There is a sense of "déjà vu" here. France has settled views on the size of the state, the scope of its welfare system, wealth and big business and it is going to be very difficult to change these even if a review is necessary in the light of present economic problems. A public sector which accounts for 56% of GDP will always "crowd out" the wealth creating private sector. As well as the disappointing PMI figures for France, referred to above, other weak indicators were a fall of 1.2% in industrial production in January, and February unemployment levels rising to a near record level. The unemployment figures rose for a 22nd consecutive month to be nearly 11% higher than a year earlier. At the moment, the French government bond market has taken all this bad economic data in its stride and government bond yields remain very low, although well above those of Germany (at the quarter end the ten year French government bond yields were 2.03% against 1.29% for the German Bund). Because of the deteriorating economic trends in France, there is increased nervousness, with the acid test coming when the government has to make decisions on public spending, given that there is hardly any scope to raise any more money by way of taxation.



Whilst the news from the eurozone is unremittingly depressing, we repeat again, and, as equity market movements show over the last quarter, it is not necessary to abandon eurozone based shares. Although the markets underperformed, they still moved higher. They can prosper much better than in their own country of domicile by virtue of diversification. In so far as the eurozone's woes weaken the currency, then it improves the value of their overseas business.

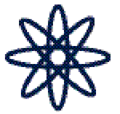
As we can see from the performance table at the beginning of this review, Japan has been a lively market and this owes itself to the election of Mr. Abe as Prime Minister giving rise to the expression "Abeomics". The Japanese economy has been plagued by slow economic growth, deflation and the largest gross level of outstanding public debt in relation to GDP of any major country, around 230%. There are enormous structural rigidities in the labour and product markets in Japan which call for a major supply side reform programme but, for the time being, Mr Abe has been concentrating on promoting an aggressive bout of monetary easing through the Bank of Japan. Whilst the Bank of Japan is independent, Mr Abe has put heavy pressure on it to raise its target inflation rate from 1% to 2% and engage in more aggressive quantitative easing. The Governor of the Bank of Japan has changed and the new nomination, Mr Kuroda, is a person more in tune with this new policy than his predecessor. Mr. Kuroda told parliament that he would take whatever measures he could to bring an end to deflation. He wants to increase the scope of asset purchases and also to increase the maturity of government bonds purchased beyond the current short term maturities. In later statements to underline the point he said that he would consider scrapping the "banknote rule". This rule meant that the amount of Japanese government bonds purchased by the Bank of Japan should stay below the amount of cash in circulation.

The effect of the proposed new policy on the market was electric. The yen has fallen sharply to the benefit of the share prices of Japanese manufacturing companies which were finding life difficult at the yen's high exchange rate. A movement either way in the yen has a significant gearing effect on profits. The prospect of the Bank of Japan buying longer dated bonds has driven down yields so that, at the end of the quarter, the ten year JGB has seen its gross redemption yield fall to 0.52%.

All of this is desperate stuff. Japan is not as vulnerable as some countries to a loss of confidence since a large majority of JGBs are held domestically. Japan also has vast foreign exchange reserves. But printing money, when public finances are so out of balance, is highly risky and risks debasing the currency. The budget deficit is expected to be around 9.0% of GDP this year. Its current account is also deteriorating as a result of its trade balance moving into deficit as a result of the need to import more energy related products following the shutdown of most of the country's nuclear power stations in the aftermath of the March 2011 tsunami and earthquake. The measures being taken in Japan are extreme. If they are successful in moving Japan into an environment of modest inflation, then, hopefully, it should encourage more spending by business and consumers as the expectations that they will be able to buy goods and services more cheaply will be changed to the opposite situation. We will see. Meanwhile, as with other countries where quantitative easing has been practised, share price dividend yields look very attractive when compared with bond yields (estimated dividend yield for this year 1.65% on the Nikkei 225 index, against 0.52% on the ten year bond yield, as mentioned above).

We move on to China, but the link here with Japan is topical, given the stand off between Japan and China over disputed islands, which has turned ugly and has affected trade with Japan and Japanese businesses in China. This is another awkward political problem in Asia and, as this is written, North Korea is making increasingly bellicose and frenetic demands in its stand off with South Korea and the USA. Whilst most people think this is posturing by North Korea, the threats have to be taken seriously and a bad outcome is not discounted by markets at present.

Whilst the Chinese economy is expected to accelerate again this year (the IMF forecasts growth of 8.2%), the authorities are showing signs of concern over inflation, which has risen from below 2% to 3.2% on its latest reading. It is attempting to control the rise in house prices which threaten general inflation problems. The Purchasing Managers indices for the manufacturing sector are both in positive territory, the official one at 50.9,

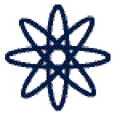


and the HSBC index at 51.6. There are strong forces in China driving change in the country's economic profile. Wages are rising quickly. This is not only official policy in order to avoid any social unrest, but also to encourage consumption and rebalance the economy away from exports. China is losing business to cheaper competitors and there is also a certain amount of "reshoring" taking place as manufacturing goes back to developed economies which could not compete when Chinese manufacturing was more competitive. As a result of Chinese costs rising, the country will move up the value added chain in terms of the profile of its production. For investors, the news coming out of China is an important driver of markets at a time when a number of advanced economies are struggling badly. For the moment, it is having a positive influence on markets.

Although the UK equity market has had a pleasing quarter, it does not reflect the struggles of the UK economy labouring under a mountain of public and private debt. As far as big companies are concerned, the majority of their business is directly or indirectly overseas so that they can, and do, benefit from their diversification. This is just reiterating the point we made earlier about eurozone countries. One may be nervous of investing in their sovereign bonds, but high quality companies represent an attractive opportunity to obtain satisfactory long term returns.

The main item of news in March for the UK was the Budget. Given the severe financial constraints under which the Chancellor operates, he had very little room for manoeuvre. Government spending and revenue are seriously out of balance and coalition politics make decisive action difficult. He has to tread a fine line, given that Moody's downgraded the UK's credit rating in February from Aaa to Aa1. It is expected that the other two agencies will follow suit in due course. Nevertheless, as our table at the beginning of this review shows, UK government bonds still sell on very low yields helped, no doubt, by the most recent eurozone troubles regarding Cyprus. A lot of hope seems to rest on the shoulders of the next Governor of the Bank of England, Mark Carney. He has a lot to live up to. With fiscal policy going to have to remain tight for as far ahead as we can see, aggressive monetary policy is going to be relied upon to drive the economy forward. However, the UK has been particularly aggressive with its policy of quantitative easing, covering around one third of the UK government bond market, far higher than in the USA or Japan. We have discussed the dangers of such a policy earlier, but desperate times call for desperate measures. Although the UK has the priceless advantage of having held on to its own currency, which enables it to have full flexibility on monetary policy, endless money printing risks currency debasement, and we have seen sterling weakening, which raises inflationary pressures. At its last meeting, the Bank of England did not enhance its bond purchasing programme but observers await the new regime at the Bank of England with interest. In this respect, the Budget gave the Bank of England extra latitude in focusing on unemployment and growth.

The Budget highlighted how difficult is the UK's economic position, overshadowed by the very poor state of its public finances. The economic growth which is needed to provide the right background for an improvement in public finances has just not been there, with forecasts having to be regularly downgraded by the Office for Budget Responsibility (OBR). In this respect, the OBR now forecasts growth of 0.6% for this year, which is half of the rate of growth forecast last autumn. The forecast for 2014 is now 1.8%, 2.3% in 2015, 2.7% in 2016 and 2.8% in 2017. Negative developments in the eurozone, an obvious source of concern, could derail these forecasts again. The public debt forecasts from the OBR is that it will be 75.9% of GDP this year, peaking at a level of 88.6% in 2016/17. Its forecast for public borrowing in 2012/13 was £114 billion, up from its forecast of £108 billion last autumn. For 2013/14, the forecast is for borrowing of £108 billion, for 2014/15 £87 billion, then £61 billion and £42 billion. These are scary figures and the experience of recent years leads to a certain pessimism, given how the original forecasts, made when the Coalition came into office, have been blown away by events. Really all the Chancellor can do is to ensure that business conditions in the UK are as conducive as possible to stimulating growth, hope that the eurozone stabilises and stops being a drag on growth and that the rest of the world can provide some stimulus. At the end of the day, the Chancellor's task would be made less difficult if some growth could be injected into the UK economy. As the Budget showed, he had hardly any room for manoeuvre. What the UK cannot do is to slow down its effort to restore some sort of order to the UK's public finances. If it reverses



its policy to borrow more to grow more, it will almost certainly face further credit downgrading, currency weakness and rising bond yields. The UK still has credibility, albeit that it is relative, and, if that were lost, the consequences would be serious. As it is, investors in UK equities, especially the large capitalisation stocks, can be reassured that they are spreading their international risk and that the market does not look expensive.

It is important that investors remain alert to the risks, economic and political, which could cause the international equity markets to experience a setback during the remaining quarters of the year, even against the background of a longer term uptrend. On the political front, we can name North Korea, Iran and the clash between Japan and China over the disputed islands. We can expect further trouble in the eurozone and, perhaps, the first departure, or departures, from the monetary union. On the economic front, we might see a further deterioration in the economic outlook for the eurozone and the UK and problems in the USA over spending as the Republicans in Congress seek to regain ground after conceding on tax increases for the wealthy last January. The outlook may worsen further for the UK as a result of events in the eurozone.

At the end of the day, though, shares still seem to be the asset class in which to be invested, firstly, because they do not look expensive unless profits collapse, which we think to be unlikely, and secondly, because no other mainstream class can compete with them, certainly not bonds. So, it may be a bumpy ride but our investment strategy remains unchanged, notwithstanding an unusually strong first quarter for international equity markets.

Meridian Asset Management (C.I.) Limited is regulated by the Jersey Financial Services Commission, under the Financial Services (Jersey) Law 1998, to carry on investment business. "Meridian" refers to Meridian Asset Management (C.I.) Limited. This document is provided for interest only. Any opinion expressed in this document is a matter of judgement at the time of writing and may be subject to change without notice. No representation or warranty, express or implied is made nor responsibility of any kind accepted as to the accuracy, completeness or correctness of the information stated herein or that material facts have been omitted. The information contained in this document is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product or service by Meridian. Various products or services referred to in this document are subject to legal and regulatory requirements in applicable jurisdictions. They may not be available in all jurisdictions. Meridian makes no representations about the suitability of the information published in this document for any purpose. It does not constitute investment advice. No information contained or referred to in this document should be construed as such. A professional adviser should be consulted with respect to your particular situation. The value of investments and the income derived from them may fluctuate and you may not receive back the amount originally invested. Past performance is no guarantee of future performance. Currency movements may also affect the value of investments. The investments and services referred to in this document may not be suitable for all investors.

© Meridian March 2013