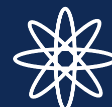

meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

The long run of steady rises in international equities markets has been broken in the first quarter although, compared to the rises seen in recent years, the falls were relatively modest, as the table below shows. International bond performances were mixed whilst, in currency markets, the yen and, to a lesser extent, sterling, were the features on the upside. There was little change in oil and gold.

The tables below detail relevant movements in markets :

International Equities 29.12.17 - 29.03.18

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-4.1	-9.3	-6.0	-8.2
Finland	+5.5	+4.2	+8.1	+5.5
France	-1.9	-3.1	+0.5	-1.9
Germany	-5.5	-6.7	-3.3	-5.5
Hong Kong, China	-0.7	-4.7	-1.1	-3.5
Italy	+3.0	+1.7	+5.5	+3.0
Japan	-5.3	-3.3	+0.3	-2.1
Netherlands	-2.4	-3.6	N/C	-2.4
Spain	-4.1	-5.3	+1.8	-4.1
Switzerland	-5.5	-7.3	-3.9	-6.1
UK	-7.3	-7.3	-3.9	-6.1
USA	-0.6	-4.2	-0.6	-2.8
All World Europe ex UK	-2.8	-4.4	-0.9	-3.2
All World Asia Pacific ex Japan	-0.9	-4.6	-1.-0	-3.4
All World Asia Pacific	-2.7	-4.1	-0.5	-2.9
All World Latin America	+5.6	+3.8	+7.7	+5.1
All World All Emerging Markets	+0.6	-2.3	+1.3	-1.1
All World	-1.9	-4.5	-1.0	-3.3

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +0.3%

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

Currency	29.12.17	29.03.18
Sterling	1.23	1.39
US Dollar	2.43	2.75
Yen	0.05	0.01
Germany (Euro)	0.43	0.43

Sterling's performance during the quarter ending 29.03.18 (%)

Currency	Quarter Ending 29.03.18
US Dollar	+3.6
Canadian Dollar	+6.7
Yen	-2.0
Euro	+1.4
Swiss Franc	+1.9
Australian Dollar	+5.5

Other currency movements during the quarter ending 29.03.18 (%)

Currency	Quarter Ending 29.03.18
US Dollar / Canadian Dollar	+3.0
US Dollar / Yen	-5.5
US Dollar / Euro	-2.2
Swiss Franc / Euro	-0.5
Euro / Yen	-3.4

Significant Commodities (US dollar terms) 29.12.17 - 29.03.18 (%)

Currency	Quarter Ending 29.03.18
Oil	+3.6
Gold	+2.5

MARKETS

A long period of mainly positive quarters came to an end in the first quarter of 2018 and the reasons for this are discussed in this economic review. Against the magnitude of rises we have seen in recent years, the overall movement for the quarter was not large but, probably more unsettling for many investors, was a return to much higher levels of volatility. In total return terms, the FTSE All World Index returned -1.9% in local currency terms, -4.5% in sterling terms, -1.0% in US dollar terms and -3.3% in euro terms. Looking at local currency returns first, the strongest performances came from the FTSE All World Latin American index with a return of +5.6% and from the FTSE All World All Emerging Markets index which returned +0.6%. In Europe, the FTSE Finland index returned +5.5% and the FTSE Italy index returned +3.0%. The UK was a particularly weak market with the FTSE UK Index returning -7.3%. In sterling terms, the FTSE All World Latin American index remained in positive territory, returning +3.8%, as did the FTSE Finland index, +4.2%, and the FTSE Italy index, +1.7%. Because of currency weakness the FTSE Australia index showed the largest negative sterling adjusted performance in our table, -9.3%.

In the international bond markets, as measured by ten year government benchmark bonds, the gross redemption yield on the UK government bond rose by 16 basis points to 1.39% and that on the equivalent US Treasury bond by 32 basis points to 2.75%. The gross redemption yield on the Japanese government bond fell by 4 basis points to 0.01%, whilst that on the German Bund remained unchanged at 0.43%. Within these movements, there were periods during the quarter of significant volatility.

In the foreign exchange markets, the stand out currencies were the yen and sterling. Although it fell by 2.0% against the yen, sterling was stronger against all of the other currencies in our list. Against the Canadian dollar it rose by 6.7%, against the Australian dollar by 5.5%, against the US dollar by 3.6%, against the Swiss Franc by 1.9% and against the euro by 1.4%.

In the commodity markets, oil and gold were slightly stronger in US dollar terms, with oil, as measured by Brent crude, rising by 3.6% and gold by 2.5%.

ECONOMICS

The sudden spike in stock market volatility in February and March raises the question of whether this portends a change in market direction or is just a random phenomenon after a long period of low volatility. We can cite two items of news which caused this first spike. Firstly, on Friday, 2nd February, the annual increase in year on year average hourly earnings of US employees came in at a higher than expected 2.9% (since revised to 2.8%). This caused investor nervousness about the trajectory of US interest rates and led to a sharp fall in the US equity market. So, over a week covering the period from the 2nd February to 8th February, when prices moved significantly both ways, on the three worst days the S & P 500 Index fell by 2.1% on 2nd February, 4.6% on 5th February and 3.8% on 8th February. Because the US equity market has been so firm for a long time, large absolute movements in the indices can look intimidating, whereas, in percentage terms, these declines were much less than a number of previous ones. It is important to make this point because the media will nearly always emphasise negative news and not put it into context. Good or unremarkable news does not make headlines and most of the time that reflects the background. In the context of investors' expectations for this year, three interest rate increases in the USA were expected and signalled by the Federal Reserve with the fourth a possibility. That the US equity market reacted badly could have

been caused by this increased chance of a fourth US interest rate increase this year as opposed to the previous general consensus of three increases. It is relevant to mention now that the 2.8% increase in average hourly earnings announced in February (the original estimate as stated above on 2nd February was 2.9%), could have been an outlier because the next month's figure, announced in March, was 2.6%. Of itself, the 2.8% increase should not have been enough to change the direction of the market because it did not bring a significant new factor into the equation. When the 2.6% figure for February was released, along with much stronger than expected non-farm payroll numbers on 9th March, it was immediately called a "goldilocks" scenario of good growth and restrained inflation, perhaps reducing the chance of a fourth interest rate increase this year. This put the market higher on the day but it was no more a meaningful guide to the direction of the market than the previous month's figure of 2.8% which spooked Wall Street at the time. The figure, just released, for March was 2.7%. So context is everything in terms of economic data but it can temporarily be sidelined by sensational media headlines which relate to a sharp market movement and cause the data to be interpreted in an unduly negative way. Commentary is not symmetrical in the sense that a good day in the market will generally not draw out headlines, but a bad day will. This is an important point because private investors can be influenced by headlines which can cause them unnecessarily to change their investment policy. History shows that the market timing of decisions to buy and sell, as opposed to a "buy and hold" strategy, can lead to sharply lower returns if done at the wrong time. At its most simple level, an investor who sells out at the bottom of the market, often referred to as capitulation, and then comes back in at a much higher level, when confidence has returned, will suffer a relatively bad performance compared with an investor who has retained his or her stance and continued to receive dividends from their shares. Given that shares have a history of long term growth, the latter type of investor will usually see a much better performance from his or her portfolio. There, of course, we are talking about the longer term situation, but the parallel with what happened on 2nd February and the days after is valid because some in the media gave the impression that a turning point in the market had been reached. Another factor of which investors should be aware is that investment has become celebrity obsessed. Some who work in the industry have developed a very high profile for themselves and a minority of those sometimes come out with extreme and headline grabbing forecasts. They may occasionally be right but markets do not generally behave in an extreme way and, at a time of 24 hour news and frenzied social media, investors must, therefore, be sure that their investment decisions relate to a considered analysis of the news and background and not be pushed into making investment decisions based on short term media pressure. The events in early February and then again in March make this investment discipline important.

There was another indirectly related event which unsettled the market, the collapse in the price in February of a short volatility note following the sharp increase in market volatility. The note had been performing well prior to the falls in the S & P 500 Index as investors bet on continued low volatility in the S & P Index but it imploded when volatility surged at the time the market fell and, between 1st February and 15th February, the note, the Velocity Shares Daily Inverse VIX Short-Term ETN, fell by over 95%. Even though it was a highly specialised note only intended for sophisticated institutional clients and did not pose a systemic risk, such an implosion resonates with some investors as reminders of what happened in the financial crisis ten years ago. At the time of writing, markets, although unsettled by the threat of a trade war and still quite volatile, seem to have got over these two events in February, but they are a reminder of two important facts. The first, as we outlined earlier, is that investors should ignore the "noise" of markets, in this case the media making much more out of one set of economic data than was justified, and, secondly, that after a long period of a steady rise in an index such as the S & P 500 with very low levels of volatility, the index is going to experience a setback, even a temporary one as we think is likely in this case, and that there will be periods of increased volatility. That is the nature of markets.

We will discuss mainly economic issues in this review in so far as they affect markets and investment decisions, but politics are very important as a background for decision making by investors and we will discuss these in relation to the USA, Italy, China and Germany and, at the end of the review, the UK.

As we have often noted in the past, protectionism is a threat to the world economy and, in this respect, President Trump's imposition of import tariffs of 25% on steel and 10% on aluminium are unwelcome. Free trade has widespread benefits and protectionism widespread costs. President Trump has indicated that trade wars are easy to win. That is not the case. There are very rarely any winners but plenty of losers. There has to be a level playing field to start with. In the case of China, against whom these measures are largely directed, excess capacity has led to subsidised prices, with manufacturers also having the benefit of cheap energy costs. There is also a significant complaint about China's gathering of intellectual property. In practice, there is not a lot that the USA can do through conventional means such as a disputes procedure, but President Trump is in the White House today because he won states like Pennsylvania, Michigan and Wisconsin in the Presidential election, albeit by small margins, on his "America First" slogan and he feels that he now has to deliver on that campaign promise. So, a narrow political group is driving a much bigger project. President Trump's action can only be explained in terms of his need to repay the voters of the affected states who helped to put him in the White House. In economic terms, whatever the justification for claiming that China subsidises its steel industry, it is very difficult to see how the USA can benefit from a trade war for, without doubt, there will be tit for tat which will escalate. Last year, the USA ran a trade deficit with China of US$375.2 billion. The President's line is that the USA is being disadvantaged by any country with which the USA runs a trade deficit. This is strange economics. There will be countries with which the USA will run a surplus and others with which it will run a deficit and these trade patterns will be for all kinds of reasons. This is a different example from the one of Germany which is running a very large current account surplus within a monetary union. But, back to China. Even though it is running this large trade surplus with the USA and therefore might seem to be in a weaker position, it can still cause problems for the USA if it decides to retaliate. For example, China tends to split its very large aircraft orders between Boeing and Airbus. It could decide to favour Airbus. From an American point of view, there are some strong negatives from imposing the proposed tariffs. The obvious one is that the price of steel and aluminum is raised. More expensive US steel or more expensive steel imports will be purchased. That will raise the price of the finished product if it contains steel. If that happens, US purchasers will have less to spend, sending negative ripples around industry and the economy generally. Rising prices might encourage the Federal Reserve to raise interest rates more than they would otherwise have done, again imposing costs on borrowers and reducing the amount available for spending. Exports containing more expensive steel will be less competitive and, at the margin, they may suffer. In summary, the only beneficiaries will be the US steel industry and those who work in it (very small in relation to the size of the US economy), and the losers, spread throughout the US economy, will be everyone else. This is a very simple linkage of events - it is more complex than that. But it makes the point that economic damage can be caused by trade wars and they reduce consumer welfare. Protectionism reduces economic activity which is negative for the stock market. One feels that the President has boxed himself into a corner with these policies and the departure of Gary Cohn, the President's Chief Economic Adviser and a free trader, is not a good sign. One must hope that wiser counsels prevail but the President is surrounding himself with those whose views veer towards protectionism. However, the President has proved himself to be unpredictable and investors have to monitor how the policy develops, since a trade war would not be good for the world economy and, by extension, the stock market.

The eurozone, having survived elections in France and the Netherlands, which could have resulted in governments with a more eurosceptic stance, ran out of good fortune, with the Italian election at the beginning of March which has resulted in the election of many more eurosceptic politicians, although it is not yet clear how they will come together to form a government, so complicated are the possible permutations. Italy matters because it is the third largest country in the eurozone and it is highly indebted. Outstanding public debt is over 130% of GDP and the Italian bond market is the third largest in the world. The economy has underperformed other large economies for a long time and it has not significantly reformed itself in a way which would enable the economy to raise its long term potential economic growth rate. The potential problem for highly indebted governments, companies or individuals will arise when interest rates rise and debt servicing becomes more expensive. Furthermore, Italy has been able to avoid problems in the debt market because of the ECB's asset purchases. Although it is illegal for the ECB to finance directly a eurozone member's debt by buying bonds in the primary market, its big bond buying programme in the secondary market has helped to suppress bond yields. This year, whilst the ECB is still engaged in its asset purchase programme, the net monthly amount of purchases has been halved from €60 billion to €30 billion and will be reviewed at the end of September when it may stop altogether or be tapered further. With a large buyer stepping back from the market at some stage, borrowers will be left to stand alone and bonds will sell at a yield which more closely reflects credit risk and yield spread. One can see that this is where the next crisis in the eurozone may start as borrowers have to stand on their own feet and to make a creditworthy proposition to potential buyers of their debt. The Italian elections showed that voters were becoming tired of austerity and that voters were attracted to parties which put Italy, rather than the eurozone (in terms of its budgetary constraints), first. The constraints of the eurozone's stability and growth pact on the size of the budget deficit are likely to be ignored, thus setting up a clash with the EU. One can see the election outcome leading to problems for the eurozone whose core members favour greater integration, especially on economic policy.

Whilst on the politics of the eurozone, one of the lesser concerns was whether Germany would be able to form a government following last year's indecisive election result. In the event, after a long delay, SPD members voted to join a grand coalition with the CDU/CSU, although the pact can be reviewed after two years. Both parties, but in particular the SPD, performed poorly in last year's election, so it is difficult to see Germany embracing too strongly France's desire for reform and more eurozone budgetary control despite struggling to rein in its own government spending. The coalition formation now means that the main opposition group in the Bundestag is the far right AfD which is opposed to closer union. All the while that there has been this political vacuum, the German economy has been performing well.

In China, the accumulation of power to President Xi Jinping has been proceeding at a rapid pace so that, not only has he had his thoughts written into the constitution, but now he could be President for life as Presidential term limits are abolished. He seems to have a stranglehold on all the levers of power, the strongest since Mao Zedong. The question is where does China go from here? A lot depends on how he uses his position of extreme power. Because he is all powerful he can get things done quickly, whether they be infrastructure or control of economic policy, say through monetary policy and directions to banks on lending, or through influence on the policies of State Owned Enterprises (SOEs). Internationally, there is China's plan to extend its influence through the Belt and Road Initiative. In a purely economic sense, one could say that, if he calls the policy decisions correctly, China can continue to flourish. The increase in wealth is there for all to see, perhaps most noticeably to those in the West in the form of the number of high spending tourists from China. There is also some clarity in policy. When China establishes a policy it tends to execute it. The danger is that, if the policy decisions turn out to be wrong, there is no forum to challenge them or, in advance of decisions being made, there is no room for alternative views for consideration.

Elsewhere, the concern that investors cannot really cater for in their investment policies remains North Korea. Investors cannot adjust their investment portfolios for the possibility of a nuclear conflagration, so devastating would that be and, looking at the relative performance of Asian markets, it seems that is the case. At present, the background is slightly more promising, with President Trump due to meet Kim Jong-un, although the meeting, if it takes place, is clouded in uncertainty. At least, there is a toning down of the belligerent noises we were hearing only recently. Whilst a portfolio construction can take into account the likely course of economic policy, for example, it is realistically impossible to take a nuclear war into account, so serious and uncertain would be the consequences. For the moment, we can only hope that the recent trend to tone down the rhetoric continues. It appears that China is turning the screw on North Korea as an examination of the trade figures shows an enormous contraction in trade between China and North Korea. This may account for the less bellicose noises coming out of North Korea and the proposal of a meeting between President Trump and Kim Jong-un.

Turning now to the economic background, the news looks generally good, with synchronised economic growth in evidence throughout most of the world. The OECD has just produced its Interim Economic Outlook projections for 2018 and 2019 which reflect an upgrade of its November 2017 forecasts. The OECD now sees growth in the world economy at 3.9% for 2018 and 3.9% for 2019, an upgrade of 0.1% for 2018 and 0.3% for 2019. Looking, firstly, at the G7 economies, the OECD has raised its forecasts for the USA for 2018 and 2019 to 2.9%, respectively increases of 0.4% and 0.7%. These are significant increases. The forecast for Germany has been raised slightly this year to 2.4% (2.3%) and for 2019 to 2.2% (1.9%). France, too, has been upgraded with growth now forecast at 2.2% (1.8%) for this year and 1.9% (1.7%) in 2019. The projections for Italy remain unchanged at 1.5% and 1.3% respectively. For the eurozone as a whole, growth projections for 2018 and 2019 have been raised by 0.2% each year to 2.3% and 2.1%. The forecast for Japan has been raised by 0.3% for 2018 to 1.5% and by 0.1% for 2019 to 1.1%. There has been a slight upgrade for the UK this year by 0.1% to 1.3% but the forecast for 2019 is left unchanged at 1.1%. The remaining member of the G7 nations, Canada, has also seen a very modest increase of 0.1% for both years to 2.2% and 2.0% respectively. Elsewhere, outside the OECD, it has slightly raised its forecast for China's growth this year to 6.7% (6.6%) and left its forecast unchanged at 6.4% for next year. India has seen a slightly bigger increase, with the OECD raising its projection by 0.2% this year to 7.2% and by 0.1% next year to 7.5%. Brazil's forecasts have been raised by 0.3% this year to 2.2% and by 0.1% next year to 2.4%. Russia, on the other hand, has seen a slight downgrade in its forecast growth this year to 1.8% (1.9%) but no change next year at 1.5%.

These forecasts represent as encouraging an economic picture as we have seen for some time and, for companies, should mean rising profits and, for shareholders, rising dividends. This background should help to underpin the equity markets even though they are undergoing an unsettled period now. However, we have to realise that we have arrived at this encouraging stage of economic growth on the back of an extraordinary monetary stimulus going back to the financial crisis ten years ago involving ultra cheap money and money creation through quantitative easing. Therefore, the quality and the sustainability of the economic recovery have to be questioned. The ballooning of central banks' balance sheets as a result of the assets they have purchased through quantitative easing has been dramatic. If we look at the USA, the size of the Federal Reserve's balance sheet is currently around US$4.4 trillion. The ECB's balance sheet is around the equivalent of US$5.6 trillion and that of the Bank of Japan is the equivalent of US$4.9 trillion. Relating these figures to the size of the respective countries' GDP, Japan stands out as the most aggressive money printer with the Bank of Japan's assets almost as large as the country's nominal GDP. The ECB comes next at nearly 40% and the Federal Reserve third at around 22%. With the Federal Reserve having stopped quantitative easing and now starting to rein back as it reinvests increasingly smaller amounts of the maturity proceeds of its assets, the percentage is starting to fall whereas, in the first two cases, the percentages are continuing to rise. The benign performance of inflation in recent years has led to some complacency but the danger of these inflated central banks' balance sheets is that, as confidence increases and money circulates around an economy

more quickly, inflationary pressures will increase and these will be hard to suppress without some dramatic and harsh tightening of monetary policy. Looking at the current policies of these three central banks, in terms of starting to reverse the policy, the USA is leading the way with the ECB some way behind and the Bank of Japan further back still. We have not discussed the Bank of England in this context but, if we did include it, it would lie somewhere between the Federal Reserve and the ECB. Almost certainly, every major central bank, even the most aggressive of them all in terms of quantitative easing, the Bank of Japan, will want to reduce the size of their balance sheets because of the risk their size entails. The key determinant of equity market movements, in the absence of anything which we cannot presently foresee, is likely to be the trade off between tighter monetary policy, i.e. an increase in interest rates and a reversal of quantitative easing and the benefits for markets which derive from a good level of economic growth, i.e. rising corporate earnings and dividends. For a long time now, shares have benefited from their relative yield attraction compared with high quality bonds and that still tends to be the case, except in the USA where ten year government bond yields are now, and have been for some time, higher than the dividend yield on US equities. Yield starved investors have looked at shares for yield. If interest rates are rising because of a satisfactory level of economic growth, which is likely to be the case this year, then equities should be able to withstand the early stages of interest rate increases because the interest rate increases are occurring for a positive reason. Some assistance will be given from rising dividends which one would expect in this environment. The danger occurs when central bank interest rate increases are behind the curve, in other words they are not rising fast enough to keep pace with the inflationary threat. If central banks lose control of inflation then they will have to act more aggressively to slow the economy, which means a tighter monetary policy than would otherwise have to be the case. In tandem with keeping on top of inflation, the central banks have to be clear in their signals to markets so that policy changes do not come as a shock. This is a delicate balance, particularly if one takes the current level of interest rates and compares them to inflation. Suppose that one was an economist who had been cut off from the world for ten years with no access to any news and had arrived back at his or her desk and told that in the USA the federal funds target rate was 1.25% - 1.50%, in the eurozone the central bank base rate was 0.00%, the Japanese base rate was -0.10% and that of the UK was 0.5%. The economist would very likely have thought that the world was experiencing deflation or very low inflation in the case of the USA. Yet the latest inflation rate in the USA, as measured by the consumer price index, is 2.2% year on year, in the eurozone 1.4%, in Japan 1.5% and, in the UK, 2.7%. The economist would be perplexed. He or she would have expected that the real rate would be positive rather than negative and, in these circumstances, official interest rates would be much higher than they are now. The dangers of such low interest rates leading to an inflationary boom and bust would have been at the front of the mind of our mythical economist. The fact that interest rates are so far away from where we might expect them to be shows the magnitude of the tasks facing the relevant central banks in steering a course towards normality in monetary policy without taking any missteps along the way which could damage the world economy.

The Bank of England has stopped its quantitative easing programme after the uplift in the programme following the Brexit vote whilst the Bank of Japan is continuing its aggressive programme, so we will consider the programmes of the US Federal Reserve and the ECB. The Federal Reserve has now started the programme of reducing the size of its balance sheet and it is doing it in a way which seems likely to cause least disturbance to the market. Rather than sell its fixed interest securities straight into the market and, therefore, perhaps cause some disruption and significant price movements as participants see a big seller coming, it is, as mentioned earlier, reinvesting increasingly less of the maturing assets which it holds on its balance sheet. So, it is almost as if no one notices, but, of course, the effect is an increasing supply of bonds to the market which, other things being equal, will raise yields. With respect to the balance sheet taper, i.e. the amount of maturing bonds which the Federal Reserve is not going to reinvest, the plan is to raise by US$10 billion each quarter this amount until the amount not reinvested each quarter rises to US$50 billion. By 2020, the Federal Reserve's balance sheet would fall to below US$3 trillion. One would think this is the most pragmatic way of achieving a reduction in the size of the Federal Reserve's balance sheet, but it is a delicate path to tread and it does require confidence to be maintained in the US economy. This is why the stand off on trade seems so misplaced. At present, we can only wait to see how this plays out. The President is capable of changing his mind

but the loss of important free traders from his circle of advisers is not good. But the USA is leading the way in the developed world in terms of economic recovery so it is logical that it should be first to move towards exiting quantitative easing.

The ECB is a long way behind the Federal Reserve in this respect but it is starting to make moves. The ECB's problem is larger because it is the central bank for a monetary union, rather than one country, as in the case of the USA, UK and Japan. One of the major problems of the euro is the "one size fits all" policy. There are 19 countries in the eurozone and they do not come near to being an homogenous bloc economically. This makes it very difficult to set interest rates correctly. For example, with the German economy strong, the current level of euro interest rates is dangerously low, threatening inflation. The country is already up against capacity constraints and wage pressures are building up. If Germany were not in a currency union it would be argued, correctly, that the German currency relative to most, if not all, of the other eurozone members would be much stronger and that the inflationary pressures would be much less but, in any case, it would still be very unlikely that interest rates would be near current levels. On the other hand, a eurozone member such as Greece would need interest rates much lower than Germany's, given the weakness of the economy. Because the ECB has to take into account the whole of the eurozone, the chances of a miscalculation on monetary policy rise. If it takes disproportionate account of the German economy and sets interest rates and its quantitative easing stance with German economic conditions in mind, it will risk economic damage to the weaker members of the eurozone. If its monetary policy is set with the latter category of eurozone countries in mind, it risks setting off inflationary pressures in Germany. The ECB's steps to monetary normality are extremely tentative at present and involve a reduction in the monthly level of asset purchases to €30 billion, compared to €60 billion last year. After September, it is unclear what happens, though these asset purchases will almost certainly stop at some stage, probably quite soon, given the good performance of the eurozone economy at present. The wording of the recent ECB statement was slightly less dovish than before, omitting language which suggested further action to support the eurozone economy, if necessary. A common currency was meant to result in economic convergence between the various countries in the eurozone so the "one size fits all" interest rate would be broadly suitable for all of them. We all know that there has not been economic convergence which makes the position problematical. The ECB will be torn between the need to tighten monetary policy, given current economic conditions in the eurozone, and awareness of the fragile nature of some eurozone members' economies which could pose a threat to the euro if there is another crisis.

As we noted earlier, the Bank of Japan has been the most aggressive central bank in terms of quantitative easing, if considered in relation to the size of the country's GDP. Although not announced, there have been signs of a slight showdown in the pace of its quantitative easing, with its latest balance sheet showing that the Bank of Japan's total assets have actually fallen. Whether this presages anything significant, we will have to wait and see. The Bank of Japan also differs from other central banks in that its asset purchase performance also includes equities, largely held through index tracking exchange traded funds and real estate investment funds. We have detailed some of the dangers of a bloated central bank balance sheet expanded through money creation and, in different ways, the USA, eurozone and the UK are vulnerable to a loss of investor confidence in their bond markets, one reason being the size of foreign official holdings of their bonds. In the case of Japan, the vast majority of Japanese Government Bonds are held internally, around 90%. This means that the JGB market is less vulnerable to a loss of confidence occasioned by foreign selling of Japanese bonds. It appears that Japan may be the last of the central banks, which have used quantitative easing as a policy tool, to reverse its policy. The Governor of the Bank of Japan, Haruhiko Kuroda, said, in January, that the Bank of Japan would "patiently" maintain its ultra easy monetary policy, with the deflationary mindset not disappearing easily. The Bank of Japan's target is to achieve its 2% target at the earliest possible date.

In the UK, the level of quantitative easing stands at £435 billion. No more quantitative easing is taking place but redemption proceeds are being reinvested. As in the USA, interest rates are on an upward path, with the next increase probably coming in May. The mood in the Monetary Policy Committee seems to be hardening, with the decision in March being a split one, 7-2 in favour of keeping interest rates unchanged. Two members voted to increase the Bank Rate to 0.75%. As indicated earlier, the Bank of England is not as far advanced as the Federal Reserve in tightening monetary policy because there does not appear to be any indication that the Bank of England's balance sheet is to be shrunk, but it is ahead of the ECB in that interest rates are almost certain to be raised this year, whereas there is no sign of this happening in the foreseeable future in the eurozone. Although inflation has eased back in the UK from 3.0% year on year in January to 2.7% in March, real interest rates, right along the yield curve, are significantly negative. The Monetary Policy Committee's thinking will be influenced by how close to full capacity the UK economy is and by its forecasts over the post Brexit period. Unlike the eurozone, at least the central bank has only one economy to think about.

Therefore, ignoring latest developments on the trade front for a moment, our theme for some time has been that the main challenge for markets, both bond and equities, in 2018 will be how they will cope with tightening monetary policy. Global money supply growth is likely to be reined in by the shrinking of the Federal Reserve's balance sheet and the reduced rate of quantitative easing pursued by the ECB, quite possibly followed by its ending. It is fair to say that the slowdown in the rate of monetary growth is causing some concern because of its effects on growth and this data bears close monitoring. On a global basis, because of what is happening and is likely to continue to keep happening on the interest rate front, the competition equities face becomes tougher, not to mention fixed interest securities. Our view has been that equities can withstand this two-pronged pressure from a tightening of monetary policy because of the level of economic growth which is likely to be achieved and its effect on corporate earnings and dividends. The extra fiscal stimulus enacted in the USA will lift US corporate earnings strongly. Any protectionist measures which reduce the rate of growth of world trade and, hence, economic growth, provide economic headwinds.

As the year started, this gradual change in the trajectory of monetary policy was what we thought would be the main drivers of share prices in 2018 and from here we will examine the economic news from the main areas of the world starting with the USA.

As we outlined earlier in our discussion of monetary policy, the US Federal Reserve, effective on 22nd March, raised its target for the federal funds rate to 1.50% to 1.75%. It did this on the basis of continued strength in the labour market and an economy which has been growing at a moderate rate. However, it noted that growth rates of household spending and business fixed investment have moderated from their strong fourth quarter readings. It also noted that inflation had continued to run below 2%, its target. The FOMC expected inflation to rise over the next twelve months to around the FOMC's objective of 2% over the medium term. The minutes said that, in view of realised and expected labour market conditions and inflation, the FOMC decided to raise the target rate for federal funds to 1.5% to 1.75%, although the stance of monetary policy remains accommodative. The decision was unanimous. The main question now is whether there will be two or three more interest rate increases this year on top of the one which has already occurred. Of course, the main economic news in the USA, prior to the recent announcement of trade measures aimed at China, was the programme of tax cuts, which the President managed to get approved by Congress following the lack of success in 2017. The measures were significant. From an economist's perspective, the extra stimulus given to an economy which was performing well carries dangers because it can lead to overheating and rising inflation, not to mention, at least initially, rising budget deficits. Supply side economists, who favour lower taxes, and the President himself believe these tax cuts will be self financing as they generate added economic growth which will produce tax revenues to match the cost of the tax cuts. Those who doubt this

proposition believe that the tax cuts will not be self funding and that the USA will be left with an increased budget deficit which will leave it vulnerable when the next recession hits the economy. For 2017, the US budget deficit was US$665 billion, which represented 3.4% of GDP. In its latest budget, the federal government has estimated that the deficit will be US$833 billion, 4.2% of GDP. If the supply-siders' hopes are not realised and the budget deficit does not react as they hope, there could be negative effects on interest rates and the currency. The latest forecasts from the FOMC, at its March meeting which raised interest rates by 0.25%, as detailed earlier, suggests that economic growth in 2018 will be 2.7%, in 2019, 2.3%, and in 2020, 2.0%. These forecasts factor in the Administration's economic policies. Its forecasts for US unemployment suggest that the current rate of 4.1% will fall to 3.8% this year and 3.6% in 2019 and 2020. The Federal Reserve's favoured inflation measure, the core Personal Consumption Expenditure (PCE Index), is forecast to be 1.9% in 2018, and 2.1% in 2019 and 2020, close to its 2.0% target. In terms of its interest rate projections, they are currently 2.1% by the end of this year, 2.7% by the end of 2019 and 2.9% by the end of 2020. By contrast, the President's Council of Economic Advisers forecasts that, as a result of the tax cuts, economic growth would rise to 3.1% in 2018 and keep it at above this rate through to 2020. So, that is quite a difference from the Federal Reserve's forecasts and therein lies the relevance for the budget deficit projections. Budget deficit levels are geared to economic growth so the faster the rate of economic growth the better the budget deficit outturn. This is what the President is counting on. The tax cuts affect individuals and businesses. For individuals who benefit, the tax cuts will give more purchasing power and, for many companies, a one off uplift in earnings per share. Factset reports that, for Q1 2018, the estimated earnings growth of companies in the S & P 500 is 17.2% year on year, with analysts projecting a 19.1% increase for Q2, a 20.8% increase for Q3 and 18.4% for Q4, an important part of these increases relating to the cut in the US corporate tax rate. For the year as a whole, analysts project earnings growth of 18.4% but, importantly, revenue growth is projected to be quite strong. Factset says that analysts are projecting revenue growth of 7.2% in Q1, 7.6% in Q2, 6.3% in Q3 and 5.5% in Q4. For the year as a whole, the projection is for a 6.6% increase. Companies can repatriate cash from abroad at a 15.5% rate. The hope is that this will stimulate business investment in the USA and provide the basis for faster economic growth. As well, there are likely to be additional returns to shareholders, either through higher dividends or share buy backs. In terms of individual indicators for the US economy, the important purchasing managers indices have given strong readings. The latest one for manufacturing stands at 59.3 and that for non-manufacturing at 58.8. As mentioned earlier, the unemployment level is low at 4.1% and expected to fall although, in the USA, there is always the qualification that the labour participation rate is low so, hopefully, a stronger economy will encourage more people to come into the labour market. Whilst an increase in real incomes is desirable and beneficial for the economy, if backed by an increase in productivity, growth should be helped by more people coming into the labour market if it does not have the effect of weakening productivity, as appears to be the case in the UK for example. Although the non-farm payroll increase was 103,000 for March and below expectations, this follows a strong reading for February at 326,000. It was also encouraging that the labour force participation rate, mentioned above, has been creeping up to 62.9%. Capacity utilisation is also rising, something the Federal Reserve will be watching. In February, it rose to 78.11%, compared with 77.42% in January. A reading of around 80% signifies an economy up against its capacity utilisation limits. Consumer confidence is also high, with the latest University of Michigan reading at 101.4, compared with 99.7 in February and 95.7 in January.

The economic news from the USA has therefore been good, which is why the opening up of the trade confrontation at this time is unfortunate. If it were not for this, we would be looking at the trade off between rising interest rates and economic growth, with monetary policy perhaps having to bear a greater burden because of the additional fiscal stimulation given to the US economy. Absent the worst case scenario over trade, we still favour significant exposure to the US equity market.

The opening up of a possible trade war between the USA and China has rather overshadowed what has been happening in the eurozone where, after a strong start to the year, there has been some tentative evidence of a slowdown, although not a serious one. The main interest has been political, namely the Italian election result, which could have implications for the eurozone. Now that Germany has a government, although possibly a fragile one given how weakened the CDU/CSU and SPD are as a result of last year's election, there will be pressure from France's President Macron for reform of the EU and more integration, which Germany may not welcome especially if it appears to be underwriting the eurozone members financially. But it is Italy where the main challenge for the eurozone is likely to lie. Because of the fragmented state of Italian politics, as shown by the election result, it is difficult to know what the make up of the government will be. What we do know is that the pro EU Democratic Party, led by Matteo Renzi, fared very badly, gaining only 22.9% of the votes in the Chamber and 23.0% in the Senate. The eurosceptic parties could, therefore, cause a problem for the EU and, by following a more nationalistic policy, such as ignoring the Stability and Growth Pact and increasing government spending, could pose a challenge to the eurozone's rules. As the third largest eurozone economy, this could be serious. Flouting the eurozone's rules would not come without a cost. With outstanding public debt at over 130% of GDP and with the end of quantitative easing probably in sight, Italy runs a risk with its credit rating if its fiscal policy becomes too lax. Quantitative easing has hidden a lot of problems but, once it has finished, and the indirect benefit of the ECB's buying in the secondary market (it cannot directly finance countries' debt) is over, countries will have to make a case for their debt to be bought at a reasonable interest rate relative to stronger credits. Italy's economic performance since it joined the eurozone has been poor and, if an economic recession were to come along, it could find itself in a very difficult position. We know that the Italian banks have a large number of non performing loans. The rate of non performing loans to total loans is around 16% and about 25% of the eurozone's non performing loans are concentrated in Italy. At the end of 2016, the gross value of Italy's non performing loans was around €325 billion, of which €200 billion were bad debts. Just these details about the level of public debt in Italy and the level of non performing loans show how vulnerable the eurozone is to political and economic events in Italy. One sign of a possible slowdown in the eurozone is a weakening in the last two months' purchasing managers indices. The January reading for the composite index was 58.8 and, in March, it had fallen to 55.2, still a reasonable level but moving, at least temporarily, in the wrong direction. Within that composite index, that for manufacturing had moved down from 59.6 in January to 56.6 in March and, that for services, from 58.0 to 54.9. It is still, of course, early in the year to know if this trend is an aberration, but eurozone companies' earnings should rise this year between high single digits and mid teens in the absence of adverse news on the trade front and an exceptionally strong euro. But we need to go back to our earlier point. The eurozone is growing as it is on the basis of substantial monetary aid in the form of negative interest rates and quantitative easing, which is continuing in its reduced form, at least until September. Although the ECB toned down its previous narrative of hinting at a continued stimulus, if necessary, at its last meeting, it would be concerning to think that it might be continuing quantitative easing for a significant time after September, since it would reflect an economy which could only show even modest growth with the stimulus of electronically created money, and we discussed earlier why there must be a limit to the size of central banks' balance sheets. There are many good eurozone companies in which we are invested but we must be under no illusion that, if we look under the bonnet, there are many problems facing the euro area arising from the problem of having a single currency in an area which is not optimal for it. These issues are likely to arise again next time there is a recession. Probably, the most important near term potential difficulty coming up is the outcome of the Italian election impasse and what it will mean for Italy's relations with the EU.

In Japan, the Prime Minister, Shinzo Abe, who had seemed to be in a powerful position to continue his reforms and economic programme following his election victory last year, has hit problems following a land sale scandal. Although Mr Abe is not implicated personally, documents about a sale of land at below market prices were falsified by the Finance Ministry and this has adversely affected the government's rating, according to a recent opinion poll. The sale of land was for a new school, of which the Prime Minister's wife was going to be the honorary principal. As with her husband, Mrs Abe has not been linked personally but the whole issue raises the questions of cronyism. For investors and the Japanese economy, a government which loses its authority will find it more difficult to enact reforms and structural reforms were the third arrow of Mr Abe's bow, the other two being fiscal and monetary policy. We will wait to see how the scandal works out as far as the delivery of policy goes but, as we saw from the latest OECD forecasts, it has raised its forecast for Japanese economic growth this year from 1.2% to 1.5%. Key to government and central bank policy is nudging inflation to 2%. The latest consumer price index for February shows a year on year increase of 1.5%, but core consumer prices, excluding food and energy, saw an increase of only 0.3%, so there is more work to do. This is what is behind the aggressive monetary measures taken to achieve higher inflation and kick start economic growth. On the basis that consumers and businesses might spend more now if they expect prices to rise rather than fall is predicated on the government's and central bank's policies. The latest purchasing managers indices from Japan suggest only modest growth. The last composite index for March showed a reading of 51.3 which covered a manufacturing PMI of 53.1 and a services PMI of 50.9. An issue for Japanese companies in 2018 could be the yen which has strengthened considerably against the US dollar since the start of the year. Last year, Japanese companies' net profits rose by 30% but the gain will be much more modest this year, perhaps in single figures because of currency headwinds. Of the major stock markets, Japan currently seems to attract least attention. Even allowing for the probability of much more modest corporate earnings growth this year, the Japanese equity market appears reasonably valued although it must be said that Japan will be nervous about potential US tariffs in spite of the apparently cordial relations between President Trump and Mr Abe.

China, on the other hand, is always in the headlines these days. Ignoring, for the moment, the trade tensions with the USA, China, if the OECD's forecasts are correct, is expected to grow only slightly more slowly than last year's level of 6.9%. Absent other factors, interest in China is likely to increase as a limited amount of "A" shares (those mostly owned by domestic investors) are included in the MSCI Emerging Markets Index and ACWI Index. Initially, "A" shares will only account for 0.7% of the index, but it is estimated that, assuming they are completely included at some stage in the future, they could account for more than 20% of the index. The "A" share market has a market capitalisation of around US$8.0 trillion and only the USA is larger. Those who take an optimistic view of China hold to the position that, although President Xi has accumulated massive powers for himself, he is still likely to espouse freer markets. Because he has accumulated so much power to himself, the key question is whether he will use it well. With the party embedding itself in many companies, foreign investors are bound to look carefully at corporate governance issues and the rights of shareholders. For the moment, investors will look at the more usual concerns about China, namely the level of private indebtedness. One advantage which China has is its ability to act quickly in the field of monetary policy by changing interest rates and bank reserve levels very quickly or, in the property market, where there have been bouts of major price inflation, taking various measures to cool it. Whilst China may have certain advantages in the way it can conduct domestic policy more easily than in, say, the USA, Japan or Europe, the trade row with the USA has opened up to full view the problems which companies can have when they deal with China. Intellectual property rights are a major problem for foreign companies, with President Trump very vocal on this issue. There is not full reciprocity on acquisitions, hence the increased difficulty which Chinese companies are having in making foreign acquisitions. It may be that the trade row with the USA, which is in no one's interest, will result in a better outcome to business relations than is currently the case if it results in renegotiations. What has been announced so far is not likely to make a great difficulty economically but the danger is that hostilities will escalate.

No country will benefit in these circumstances and protectionism can easily lead to a recession. When it was announced last year that Chinese “A” shares were to be admitted, in a limited way, to the MSCI Emerging Markets and ACWI Index, there was a different political scene in China and, although protectionism had been advocated by President Trump, he had other issues on his mind. Now they have reacted to his “to do” list and investors will have to await developments as indeed they will for other Asian and emerging markets where economic prospects generally look encouraging.

The UK has been a relatively disappointing performer and it has been our view ever since last June’s General Election that political risk had become significantly elevated and, with that, the market risk. Politics is as important as economics and, especially so, when the divisions between the two main parties are so wide. Of course, it is only about nine months since the last General Election and the next one is not due until 2022. It is also not as easy to call a General Election now because of the Fixed Term Parliament Act which means that the government would have to lose a no confidence motion or that two thirds of MPs would have to support the motion to hold one election early. So, it is not easy to call a General Election but it is possible and, in the case of the two scenarios outlined above, the loss of a no confidence vote, perhaps because of the agreement with the Democratic Unionists breaking down, is the more likely. At this stage, this is only a possibility and it is more likely that the next General Election will be in 2022. However, what investors have to consider is that, with the two main political parties roughly level in the opinion polls, it is possible that there will be a change of government at the next election. If that is the case, on policies as announced, it would represent an enormous change in the way the economy is managed, with large scale nationalisation of industries and PFI contracts and much higher taxes on many people’s income and, quite possibly, wealth. There would be no guarantee that prices to be paid for acquired assets would represent market prices. It is difficult to think of another major country which plans to move in this direction. Many of the affected businesses are foreign owned and it is likely there would be major legal battles around compensation. The important point for investors, and one reason why the UK stock market is the least favoured by international investors, is that, for the above reasons, it is perceived to be high risk, even though, fundamentally, it looks good value. For this view of the UK to change, there would need to be a change in the political landscape in the UK. This is the reason why we maintain a large overseas overweighting in our clients’ portfolios where the mandate allows. Should there be a change in government, or an increasing likelihood of one, sterling and the stock market could be expected to reflect this. We think the UK political situation is a greater risk to the market than Brexit, for the former would presage a massive increase in state intervention and higher taxation, features one would not associate with a strong stock market.

In normal times, we would usually give more weight to economic than political factors in assessing the prospects for most markets but, for the reasons just mentioned, it is the reverse on this occasion. It is important to note, however, that economic conditions in the UK are reasonably satisfactory, even though the OECD forecasts the UK’s growth to be the lowest of the G7 countries this year and equal lowest next year. A number of G7 countries, however, coming out of the financial crisis grew less than the UK, so that there is an element of catching up. Looking ahead, in its Inflation Report, published in February, the Bank of England’s projections show GDP growth averaging 1.75% over the next three years, but using up the diminished supply growth of capacity of the UK economy which it projects at around 1.5% per year. This would be consistent with a rise in short term interest rates which are implied at 1.2% in three years time. Inflation, by then, could be 2.1% based on GDP projections. Historically, this would be a very low bank rate relative to inflation. The forecast cliff edge for the economy after the Brexit note has not materialised and the positive points for the UK economy, at a time when the media always seems to accentuate the negative, are worth noting. They include low unemployment with near record numbers in employment, public finances improving more quickly than expected and tentative signs of improving productivity. This latter point is very important because the holy grail would be rising real incomes bolstered by productivity increases. Absent the political uncertainty, we believe investors would be more inclined to view the UK on more traditional grounds but we feel that the cautious approach is justified for the time being.

Bond market yields have been suppressed for a long time by quantitative easing and extreme monetary policy measures, which have been followed since the financial crisis ten years ago, and they now face the challenge posed by a tightening of policy and the reversal, or scaling back, of quantitative easing. As large buyers in the form of central banks start to scale back their balance sheets, one would expect bonds, which we consider to be expensive almost everywhere, to reflect this and for yields to push considerably higher. This is a big challenge to the bond markets and we remain negative on their prospects.

Although the fact that it has been a negative quarter for equity markets, and we have been warning in these reviews that, after so many positive quarters, it is certain that there would be negative ones from time to time, it inevitably calls into question one's investment view of the attractions of different asset classes. The complication is the possibility of the trade stand off between the USA and China escalating. As things stand, although there has been a lot of noise, what has happened or being suggested, is not likely to have a big effect on world growth. One has to hope that wiser counsels prevail. There are two sides to the argument and it is in both side's interest for there to be an accommodation of views. If this difficult development can be considered sensibly, the balance for investors is assessing how the forces of monetary tightening and reduced rates of monetary growth can balance against reasonably good economic prospects. If central banks get their signalling right and provide no unwelcome shocks for investors, the background should remain supportive for equity investors, although more uneven returns may be seen. But, for the long term investor, especially those who are sterling based, an internationally diversified equity portfolio, in the absence of any portfolio constraints, remains our preferred policy.

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