meridian

ASSET MANAGEMENT (C.I.) LIMITED

# INVESTMENT MEMORANDUM

The relatively minor movements in international equity markets during the last quarter do not do justice to the underlying volatility of markets against a dreadful geopolitical background. In fact, partly because of sterling's weakness, sterling based investors will generally have seen little change in values over the quarter, but the same cannot be said for bond investors who have endured a poor quarter as interest rates have risen.

The tables below detail relevant movements in markets :

## International Equities 28.02.22 - 31.05.22

| Total Return Performances (%) | | | | |
|---|---|---|---|---|
| **Country** | **Local Currency** | **£** | **US$** | **€** |
| Australia | +4.6 | +10.1 | +3.4 | +8.4 |
| Finland | +2.6 | +4.2 | -2.2 | +2.6 |
| France | -0.6 | +1.0 | -5.2 | -0.6 |
| Germany | -2.8 | -1.3 | -7.3 | -2.8 |
| Hong Kong, China | -3.5 | +2.3 | -3.9 | +0.8 |
| Italy | -1.7 | -0.2 | -6.3 | -1.7 |
| Japan | +3.0 | -1.8 | -7.8 | -3.3 |
| Netherlands | -6.7 | -5.3 | -11.0 | -6.7 |
| Spain | +6.3 | +7.9 | +1.4 | +6.3 |
| Switzerland | -1.3 | +0.6 | -5.6 | -1.0 |
| UK | +3.4 | +3.4 | -2.9 | +1.9 |
| USA | -6.0 | +0.1 | -6.0 | -1.4 |
| All World Europe ex UK | -2.5 | -0.9 | -6.9 | -2.4 |
| All World Asia Pacific ex Japan | -3.5 | +0.8 | -5.3 | -0.7 |
| All World Asia Pacific | -1.4 | -0.1 | -6.1 | -1.6 |
| All World Latin America | +0.7 | +14.2 | +7.3 | +12.5 |
| All World All Emerging Markets | -6.2 | -1.1 | -7.1 | -2.6 |
| All World | -4.1 | +0.4 | -5.7 | -1.1 |

*Source : FTSE All World Indices*

FTSE UK Government Securities Index All Stocks (total return) : -7.7%

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

| Currency | 28.02.22 | 31.05.22 |
|---|---|---|
| Sterling | 1.41 | 2.10 |
| US Dollar | 1.83 | 2.85 |
| Yen | 0.19 | 0.24 |
| Germany (Euro) | 0.13 | 1.12 |

## Sterling's performance during the quarter ending 31.05.22 (%)

| Currency | Quarter Ending 31.05.22 |
|---|---|
| US Dollar | -6.1 |
| Canadian Dollar | -6.3 |
| Yen | +5.0 |
| Euro | -1.9 |
| Swiss Franc | -1.8 |
| Australian Dollar | -4.9 |

## Other currency movements during the quarter ending 31.05.22 (%)

| Currency | Quarter Ending 31.05.22 |
|---|---|
| US Dollar / Canadian Dollar | -0.4 |
| US Dollar / Yen | +11.7 |
| US Dollar / Euro | +4.4 |
| Swiss Franc / Euro | +0.1 |
| Euro / Yen | +7.0 |

## Significant Commodities (US dollar terms) 28.02.22 - 31.05.22 (%)

| Currency | Quarter Ending 31.05.22 |
|---|---|
| Oil | +20.0 |
| Gold | -1.6 |

# MARKETS

Given the geopolitical and economic turmoil in the world over the last quarter, the relatively modest movements in the FTSE All World indices might seem surprising, although, within these minor movements overall, we have seen periods of significant volatility during the quarter.

In local currency terms, the FTSE All World Index has returned -4.1%, +0.4% in sterling terms, -5.7% in US dollar terms and -1.1% in euro terms.  Looking at local currency movements first, the stand out movements on the positive side have been the FTSE Australia Index (+4.6%), the FTSE UK Index (+3.4%) and the FTSE Japan Index (+3.0%).  Within the FTSE Europe ex UK Index, the Spanish market was notable, with the FTSE Spain Index returning +6.3%.  There were no really significant underperformers, but it is worth noting the FTSE USA Index (-6.0%) and the FTSE All World All Emerging Markets Index (-6.2%).  However, in sterling terms, the picture changes.  Joining the FTSE Australia Index (+10.1%) as a stand out performer was the FTSE All World Latin America Index (+14.2%) where currency effects were notably positive.  The FTSE USA Index (+0.1%) just moved into positive territory.

Fixed interest securities endured a poor quarter.  Taking ten year benchmark government bond yields, the gross redemption yield on the UK gilt rose by 69 basis points to 2.10%, that on the US Treasury bond by 102 basis points to 2.85%, that on the Japanese Government bond by 5 basis points to 0.24% (the Bank of Japan operates a yield control policy, so circumstances are different here) and, on the German Bund, by 99 basis points to 1.12%, well away from earlier negative territory.

In the foreign exchange markets, sterling performed poorly, rising only against a very weak yen by 5.0%.  Against the Canadian dollar sterling fell by 6.3%, against the US dollar by 6.1%, against the Australian dollar by 4.9%, against the euro by 1.9% and against the Swiss Franc by 1.8%.

In the commodity markets, disrupted by the Russian invasion of Ukraine which has affected hard and soft commodities, oil, as measured by Brent crude, rose by 20.0% over the quarter.  Gold, perhaps surprisingly, fell by1.6% with the move to rising interest rates probably being a factor.

# ECONOMICS

If you happen to be running a country at the moment there is plenty of choice around what to be most worried about. A cynic (what place for cynicism in politics?) might imagine that political survival is the number one goal and that means one eye needs to be kept on the next election, then there is the opposition and, to be feared in equal measure, one's own party. Political survival, in those terms, is about public opinion and, for all good and fair democracies, the voter's worries should also be those of the political elite. Remaining in power is no party.

The focus of many at the moment has rapidly become the affordability of common or garden goods and services and this is probably something that many have not had to worry about for some time. The last period of galloping inflation in the United Kingdom, and in most other developed economies, was the 1970s, meaning that only those in their 60s or older have any practical understanding of its effects.  As well as those who find their shopping and the cost to heat the home rising sharply, others with a particular interest in inflation would be the chiefs of the central banks who are paid to worry about such matters and would claim to have a better understanding of the causes and cures than anybody else.  We have seen in May that they are only human, with current U.S. Treasury Secretary/ former head of the Federal Reserve, Janet Yellen, admitting on television that she was wrong about the path that inflation would take.  Given that her wise counsel is her stock in trade this must have been quite a difficult interview for her.  Closer to home, the Governor of the Bank of England has faced criticism of his handling of the buying power of the pound explaining that the central bank is walking a “narrow path” between holding back price rises and triggering a recession. Central bankers had been enjoying a period of being held in the highest regard, their steady hand on the strong levers of policy having steered the economy past two extreme events.

Whilst events in history do repeat themselves it would be hard to describe history as cyclical whereas an early lesson in economic theory is the subject of the economic cycle, though, just as history has facets that do repeat, every time round in the economic cycle the causes are different. With that in mind there are some parallels with the 1970s at present: a belligerent Russia threatening the West, double digit inflation and somewhere between the two is a war-induced energy crisis. We shall resist the temptation to stretch the comparison to include a jubilee celebration, a potential national rail strike and a popularity surge for Abba.

This economic memorandum is not the best place to judge the wrongs and wrongs of Russia’s invasion of Ukraine yet it’s important to make some reference to the human suffering to balance the notion that the economic spill over of the conflict concerns us more directly. The nature of warfare has changed over past centuries and will continue to change, usually re-shaped by new technology but, what is also noteworthy is how everyman’s perception of it has moved. The heroism and glory of conquest and crusade is now just the phone footage of slaughter and devastation across playgrounds and tower blocks. Given the horrors, even sanitised for the daily television news, worrying about its economic effects in our homelands seems, almost, to trivialise Ukraine’s suffering. It is not meant to.

It now seems that the war will grind on, as, at the time of writing the 100th day of conflict passes. Western countries, led most generously by the United States, are galvanised in their opposition to Russia’s expansion and the supplying of sophisticated military hardware is, doubtless, reinforcing the victories of the defiant Ukrainian military. Whilst everything bar the first moments of warfare is unpredictable, security intelligence reports that Vladimir Putin is far from unpredictable: he is unyielding and relentless in the pursuit of his established goals but such is the nature of warfare that it can never follow a predetermined plan as unknowns reveal themselves, such as the ongoing resilience and morale of both sides, the political support for opponents and even ephemeral issues such as the weather come in to play. Equally, it is possible that the pre-determined plan did not allow for the economic victims around the globe. The inflated price of pasta in our supermarkets is inconvenient but for developing countries, a food crisis looms.

Comparisons with the 1970s are also being drawn as rapid price rises affect consumer purchasing power, which, as a concern, has been increasingly absent since, in fact, at times it has been a tilt into deflation that threatened to take hold but didn’t. In economic terms, it is hoped that much has been learnt from the 1970s where rapid expansion of the money supply in countries such as UK and US, coinciding with two energy crises and central bank focus on employment rather than inflation caused great financial damage and a loss of confidence among consumers. In both countries it was monetary tightening at the end of that troubled decade that rectified the situation.

Using the United States as a reference case, that decade was characterised by expansionary economic policy where there was a focus on unemployment levels. The belief was that there was a trade off to be had and higher inflation was a price to pay for lower unemployment. Government spending increased through this period with the effect that the money supply expanded faster than the rate of growth. This period also coincided with the de-tethering of the dollar from gold. Inflation was more controllable when the dollar was anchored to something and there was the option of converting dollars into gold at a fixed rate. There followed two fuel crises, firstly in 1973 when OPEC flexed its muscles and, secondly, as a consequence of trouble in the Middle East in 1979 which, to use a metaphor that is not far from the reality, had the effect of pouring fuel on to the fire. It was clear by the end of 1970s that the previously understood model-based relationship between unemployment and inflation did not hold true. The situation was only brought under control at the beginning of 1980s when the new head of the Federal Reserve was announced as Paul Volcker, who, in part, had been chosen for his views on the risks to public confidence and, with it, the economy caused by inflation.

Bringing the narrative back up to date we now see high energy prices, as we did then, but caused by very different events and we see supply side inflation caused by something we haven't experienced for a long time - a pandemic. We are now in an age where precise, metronomic supply lines across distant international borders have been shaken by, firstly, the pandemic and, secondly, the uneven exit from the pandemic. China's manufacturing output continues to be limited by its adherence to its zero COVID strategy with, for example, Shanghai, a city of 25 million pushed into lockdown for 65 days, 56 days longer than originally planned. Easing of the rules started on 31st May.

Coronavirus has caused three things to happen, all of them shaping the current situation: firstly, many workers have exited the job market. Secondly, there has been, and still, is supply side disruption and, thirdly, the pandemic caused deferred demand. All of these point to the economic long-COVID of inflation. War has caused two things to happen. Commodity prices have risen and supply side issues have been amplified and this is worth considering because we find ourselves in a position where on the one hand high inflation and super-loose monetary conditions exist and on the other, we see full employment and forecast world growth of 3.6% in 2022, according to the IMF's most recent estimates.

The post-crisis spurt of economic growth has created the space for there to be a reversal in the direction of travel of monetary policy from quantitative easing to quantitative tightening though evidence grows that the response to the leap in inflation has come too little, too late with cost-push inflation and higher wage demands amid a dearth of workers, pushing up the cost of labour. As well as the tidal change in monetary policy with quantitative easing and ever lower interest rates yielding to quantitative tightening and rising borrowing costs, we now see divergent central bank policy where the United States stands out, being the largest single economy in the world, but also with its more aggressive approach to tightening. It now looks as though the Fed will be raising dollar interest rates at a number of its next monthly meetings. It's important to remind ourselves that interest rates continue to be incredibly low, in the context of history; if a curious visitor arrived on planet earth today and it was explained what inflationary pressures currently are, where debt levels are and asked to guess prevailing interest rates, it's not likely many of these visiting alien economists would be correct. The word 'correct' is used advisedly here because it refers only to the guess being numerically accurate.

A consequence of the strengthening dollar has been, as is usually the case, a distressed developing economies' bond market with emerging market debt having the worst start to the year for many years. All emerging markets have a number of differing domestic issues to contend with but they can hardly be blamed for US dollar interest rate rises, the global effects of the pandemic and a distant war. In May, Sri Lanka became the first country in Asia Pacific to default on its debt in more than two decades and this points to a fourth effect of COVID - the damage done to countries which depend on hard currencies flowing in via the wallets of tourists. This has brought its economy to this tipping point but there are a number of other factors in its recent history which contribute to the default. In 2019 it had $7.9 billion of foreign reserves and today the country cannot pay for food or medical imports. It is not clear at present whether this island state is a unique victim of its own mistakes or whether it is a canary in the coal mine for other emerging market countries, but the IMF and World Bank are visiting a number of countries at present.

Bond markets have performed poorly over the last six months. Sensitivities to inflation inevitably feed into yields as any period of inflation has an effect on the present value of the principal due to be re-paid at some point in the future. If inflation becomes entrenched and a multi-year phenomenon, then the compounding effect of price rise on price rise will provide a renewed threat to the price of bonds in the markets.

Inflation, and the threat it poses, namely an economy pushed above the neutral point of interest rate policy, would be having the largest effect on the falls in bond and equity values at this time as its emergence undermines the value of an income stream or future repayment of capital. Looking at the sectors of the equity markets which have fallen most this year a pattern emerges quite quickly which is in many cases a reversal of what has been happening up to this point. Technology shares, which have grown spectacularly in value over recent years, make up a sector which has suffered a large fall back. A common metric used in valuing companies is the price/earnings (P/E) ratio where the share price is a multiple of the company's profit per share and could be considered to be the number of years of profit it would take to repay the holder the amount they have paid for the share. As the share price grows the P/E ratio also increases for a given level of profitability. Equally an increase in profits which is not matched by growth in the share price causes the P/E ratio to fall. Enthusiastic buyers of tech stocks have driven their prices up to stratospheric levels which investors were justifying by forecasting exceedingly high levels of growth well into the future. As inflation bites, those future (and often distant) income streams become worth far less in today's money, causing downward pressure on the share price. This is compounded by the economic effects of inflation reducing growth as consumer buying power decreases, leading companies to revise downwards their corporate growth rates accordingly. This would also, most likely, lead to a reduction in profitability. P/E ratios for the largest tech companies in the world have reduced significantly as their share prices have fallen and, as an aside, Apple and Microsoft have traded the position of world's most valuable company over the past years but neither now holds this title following their falls in value, overtaken by Saudi oil giant Aramco. It says a lot about 2022 that an oil company has overcome a tech company to become the most valuable company in the world.

At times like this it is inevitable that investors reflect on losses they are likely to have made in their portfolios; it is also human nature that a loss inspires a greater emotional reaction than a gain of the same amount. Like other investment managers we tend to look at performance in percentage terms and very often the measure is in terms of how much markets have fallen from their peak with the FTSE All-World index total return in sterling terms (gross dividends) down 5.9% at the end of May from December 2021. Perhaps another way of looking at the falls is how many months of growth have been lost, or, put in other words, how many months has the market been set back. Returning to the benchmark performance earlier in this paragraph the FTSE All-World Index has retreated to the level it was last at in August 2021, or, roughly nine months' growth and income has been enjoyed and then taken back. The purpose of expressing it in this way is to highlight the extraordinary growth levels that equity markets have enjoyed for over a decade. A secondary point is that further losses are possible as we adapt to being in an economic dynamic with higher inflation and higher interest rates. The warning from history here is that, in our view, the temptation to sell out to minimise losses should be resisted. Looking at a long term performance chart it becomes easy to imagine having sold at the peaks, buying back at the troughs. Again, in our opinion, a more important conclusion is that by remaining invested throughout, the investor is guaranteed to participate in the recovery but will not know when that recovery will take place. Provided the investment horizon is long enough, and a generally accepted time scale for equities is five years, then it is very unlikely that the investor will be worse off. March 2020 is the most recent example of a sharp fall in the market followed by a period of recovery. The All-World index fell 25% in 25 days but still finished the year in positive territory. The point here is not to attempt to imagine a parallel with the speed of market recovery but, rather, to warn against a selling down of positions when fear is all around. All asset markets are vulnerable to sharp, downward adjustments and such is the world's exposure to equities, when the stock market does fall sharply, it becomes a subject of broad discussion. The market's vulnerability to shock falls will remain, yet there is every reason to believe that all such falls will be followed by a recovery.