meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Given the dramatic developments over the quarter, the outcome for this period, showing broadly stable equity prices and falling high quality bond yields, must be considered a satisfactory result, perhaps suggesting that investors are becoming inured to the volume of unsettling and unexpected events in all sorts of fields. As our review suggests, there is no room for complacency, but the reasonably good outlook for the world economy gives some cause for optimism.

The tables below detail relevant movements in markets :

International Equities 28.02.11 - 31.05.11

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-1.7	+1.6	+2.8	-1.2
Finland	-1.7	+1.1	+2.2	-1.7
France	+0.8	+3.7	+5.0	+0.8
Germany	+0.3	+3.1	+4.3	+0.3
Hong Kong, China	+6.1	+5.0	+6.3	+2.1
Italy	-3.6	-0.9	+0.3	-3.6
Japan	-10.9	-11.2	-10.1	-13.6
Netherlands	-4.5	-1.8	+0.6	-4.5
Spain	-2.3	+0.5	+1.7	-2.3
Switzerland	+1.4	+9.2	+10.6	+6.2
UK	+0.9	+0.9	+2.1	-1.9
USA	+1.9	+0.7	+1.9	-2.1
Europe ex UK	N/C	+3.6	+4.8	+0.7
Asia Pacific ex Japan	+3.8	+6.2	+7.5	+3.3
Asia Pacific	-3.1	-2.0	-0.8	-4.7
Latin America	-3.2	-0.1	+1.1	-10.8
All World All Emerging	+2.1	+3.2	+4.4	+1.2
The World	+0.1	+0.6	+1.8	-2.2

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +3.5%

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

Currency	28.02.11	31.05.11
Sterling	3.69	3.31
US Dollar	3.42	3.05
Yen	1.26	1.16
Germany (Euro)	3.17	3.03

Sterling's performance during the quarter ending 31.05.11 (%)

Currency	Quarter Ending 31.05.11
US Dollar	+1.1
Canadian Dollar	+0.7
Yen	+0.5
Euro	-2.9
Swiss Franc	-7.2
Australian dollar	-3.4

Other currency movements during the quarter ending 31.05.11 (%)

Currency	Quarter Ending 31.05.11
US Dollar/Canadian Dollar	-0.5
US Dollar/Yen	-0.6
US Dollar/Euro	-4.0
Swiss Franc/Euro	+4.6
Euro/Yen	+3.5

Significant Commodities (US dollar terms) 28.02.11 - 31.05.11 (%)

Significant Commodities	28.02.11 - 31.05.11
Oil	+4.4
Gold	+8.8

Markets

Against a background of terrible natural disasters, radiation concerns in Japan and military action in Libya, markets have remained remarkably calm. There has been very little change in world equity markets in the quarter, as measured by the total return on the FTSE World Index. In local currency terms, on a total return basis, the FTSE World Index returned +0.1%, in sterling terms +0.6%, in US dollar terms +1.8% and in euro terms -2.2%. Looking at local currency returns, the only real sharp movement came from Japan, which returned -10.9% in the aftermath of the earthquake and tsunami. The best performances came from the FTSE Asia Pacific ex Japan Index, +3.8%, and the FTSE All World All Emerging Markets Index, +2.1%. The picture changes when we look at the sterling adjusted returns. There was a further slight deterioration in the return on the FTSE Japanese index to -11.2%, and the returns on the FTSE Asia Pacific ex Japan Index and the FTSE All World All Emerging Markets Index were enhanced to 6.2% and 3.2% respectively. Because of the strength of the European currencies against sterling, particularly the Swiss Franc, the FTSE Europe ex UK Index moved from being unchanged in local currency terms to +3.6% in sterling terms with the stand out performer being Switzerland where the local currency return on the FTSE Switzerland Index moved from +1.4% in local currency terms to +9.2% in sterling terms. The strength of the Australian dollar meant that a minor negative movement, in local currency terms, in the FTSE Australian Index of -1.7% became +1.6% in sterling terms. With the US dollar slightly weaker, a local currency return of +1.9% from the FTSE USA Index became +0.7% in sterling terms.

High quality bonds performed well as they benefited from concerns about the fate of some countries' eurozone sovereign debt and, within the eurozone, Germany, as the strongest eurozone credit, saw the gross redemption yield on its ten year bonds fall by 14 basis points to 3.03%. UK gilts performed well, with the gross redemption yield on the ten year bond falling by 38 basis points to 3.31%. It was a similar story for US Treasuries, where the relevant yield fell by 37 basis points to 3.05%. The ten year Japanese government bond yield fell by 10 basis points to 1.16%.

In the currency markets, the main feature was a rampant Swiss Franc, against which sterling fell by 7.2%. The euro was also stronger during the quarter, with sterling showing a decline against it of 2.9%. Sterling also declined against the Australian dollar, falling by 3.4%. Sterling rose slightly against the US dollar, Canadian dollar and yen by 1.1%, 0.7% and 0.5% respectively.

In the commodity markets, oil fell back from its peak during the quarter, but still rose by 4.4% in US dollar terms. Gold continued to perform well, rising by 8.8%.

Economics

The number and intensity of serious unexpected events this year cannot hide the continued existence of perhaps the most serious long term economic issue of all, the eurozone's sovereign debt crisis. The problem seems intractable and, as we said in a recent review, it will certainly not have a happy ending. It goes from bad to worse, one reason being the disagreements amongst the various policymakers. Of course, from time to time, it unsettles markets even though, given the extraordinary events so far this year, the equity markets have shown impressive resilience, broadly holding on to their gains of the last two years.

The problems of the eurozone have dominated many of our recent reviews and are likely to continue to do so for the foreseeable future for they are not going to go away. It is inevitable that this problem must be the starting point for our current review. Although independent observers, backed up by the market, recognise that Greece cannot repay its creditors in full and, quite possibly, this will be the case with Ireland and Portugal and, possibly, Spain, those officially involved cannot bring themselves to say it. We have, therefore, seen euphemisms like "soft restructuring" or "debt reprofiling", but neither of these expressions, or any others which may be invented, will fool investors. As this is written, Greek three year government bonds yield 26.2% and nine year bonds 17.2%. There are a number of reasons why various parties are in denial about the problem. For the governments of the affected countries, the embarrassment is obvious, both politically and economically. Incumbent governments tend to get blamed for the problems, witness the heavy defeat of the last Irish government in the recent General Election and the defeat of the Spanish socialists in the recent local elections. The Greek government continues to deny that a restructuring of its debts will be necessary but its stance lacks any credibility. Meanwhile, it faces regular strikes and protests and is behind with its agreed measures to help to deal with the problem. It continues to be pressurised by the EU and IMF to get its reform and retrenchment programme on track but faces significant domestic opposition, including from within its own party which, for example, is ideologically opposed to privatisation in many cases. The ECB is opposed to restructuring because, having already lowered its quality threshold for collateral received from banks in exchange for providing liquidity, it would have to reject Greek banks' collateral, thus bringing about a crisis in the Greek banking system because it would be denied a key source of funding. The contagion would spread to other countries. The issue goes back to the fundamental flaw in the monetary union. Holders of eurozone government bonds such as, importantly, banks, did not distinguish sufficiently between the quality of the issues. A euro was regarded as a euro, never mind where the liability lay. It was not so many years ago that Spanish bonds almost stood on a par with German government bonds, as far as yields were concerned, and Greek bonds on only about a 25 basis point yield premium. The mindset was that as long as the asset was in euros, the name of the issuer did not matter. This is an oversimplification, of course, but it makes the point about the lack of discrimination amongst the various credits by lenders. Almost certainly, were the old legacy currencies in place, this would not have happened, because lenders would have received market signals from the relevant currency and interest rates. The problem for Greece and, probably, Ireland and Portugal and, possibly Spain, is that they will find it impossible, at current interest levels at which their credit is priced, to grow fast enough to service and stabilise their debt. The measures which are being imposed on these countries, and Greece is the most extreme example, will make any growth very difficult. So, in a sense, they are self defeating. If these countries were not part of a currency union, the traditional remedy administered by the IMF in return for support would include a devaluation to help the adjustment process and to make the country more competitive. Without this escape route, the move towards restoring their competitiveness encompasses severe deflationary measures, such as wage cuts, which are being experienced. In a democracy, one wonders how much more the citizens of these countries will take and whether a government or governments in any of these countries will lose their nerve. But the other side of the coin is that the electorates in the relatively successful eurozone countries, and Germany and Finland particularly come to mind, are becoming increasingly unsettled by the bail outs to countries they regard as having been fiscally profligate. The success of the eurosceptic True Finns in the country's recent general election and the increasing pressure on the German Chancellor, are indicators of the respective electorate's dissatisfaction. The greater the guarantees given by the strong eurozone countries, the more they are at risk and the weaker will become their credit rating. A fundamental flaw in the monetary union is that there was no accompanying fiscal union which, in any case, would have been a step too far for the electorates. But without a mechanism for fiscal transfers, such as there is in the USA, for example, the euro project is incomplete. In a way, the establishment of the bail out mechanisms is a step towards this. How the eurozone leaders' attachment to the euro plays against increasingly hostile noises from the electorates of the strong and weak eurozone countries, remains to be seen. For the moment, the politicians of the eurozone and the central bankers at the ECB will be very concerned about the implications for the eurozone's banks if there is a Greek default which the polite expressions "soft restructuring" and "debt reprofiling" cannot hide.

The eurozone has put in place the European Financial Stability Facility to help troubled eurozone countries in the short term and, after that, the European Stability Mechanism to take its place from 2013. But the latter will involve the private sector sharing the burden of any defaults rather than their being socialised, as at present. Obviously, this is going to make access to the credit markets much more difficult for troubled eurozone members because the risk of losses will deter potential investors.

It is felt that the eurozone can just about deal with bailouts for Greece, Ireland and Portugal, but the red line is Spain, the eurozone's fourth largest economy. Nerves have become frayed by the government's heavy losses in the recent local elections and a general election is due next year. The problem is that whereas the government has made progress at the national level in addressing its budgetary problems, the degree of devolution in Spain to local regions is a weakness as they are heavily indebted and more difficult to deal with. Nerves have become even more frayed after Standard & Poors's said that it had cut the outlook on Italy's A+ rating because of worries over the Italian economy. The market gives a clear signal about its thoughts and, at present, it is showing a measure of concern about Spanish and Italian credits. If we take ten year government bonds as a benchmark, that of Germany is yielding 252 basis points below the equivalent Spanish government bonds and 179 basis points below those of Italy. All the time, we have to realise that the absolute level of top quality bond yields is low. Were they to rise to more normal levels, the problems for these hard pressed eurozone countries would be worse. Although the ECB looks as if it may stay its hand a bit longer before raising interest rates again, the trend of short term interest rates is likely to be upwards as eurozone inflation is well above target.

Can anything positive come out of this for the eurozone countries which are suffering so badly at present? The answer is that it could in the medium and long term. Some of the countries suffer from structural rigidities in their economies which restrain their growth potential. The supply side reforms which are being forced upon them should improve their medium and long term potential but that is not going to happen overnight. This is a fast moving drama and very difficult to know how it will end. For instance, as this is written, parts of the eurozone are pressing to take control of Greece's privatisation programme, a key plank in the bail out plan. It is true that

Greece has been dragging its feet on the bail out agreement, but one can only imagine the response of the Greek electorate to what would be tantamount to a takeover of part of its economy. But the seriousness of the position is shown by a quote from the Dutch Finance Minister who said that such considerations should be set aside. He said "right now, we are beyond sensitivities. Our common predicament is simply too serious". This is strong stuff but highlights the desperate predicament in which the eurozone finds itself. If we had to make a guess at the short term solution to the threat of a banking crisis, it will be that, with the greatest reluctance, the ECB will continue to accept Greek government bonds as collateral for Greek banks' liquidity requirements. Ideally, it would be without any announcement of an official restructuring so that the no default pretence can last and collateral can continue to be accepted by the ECB. In this appalling position in which the eurozone now finds itself, one may ask if there is anything safe in which one can invest. At the end of the day, money can be printed but it results in currency debasement. In these circumstances, assets which can provide some protection against inflation, like shares, property and commodities, have appeal. This is an oversimplification, because macro economic influences can affect any of these asset classes but their relative appeal against bonds is obvious and, as we have said before, the outlook for the world economy as a whole is not bad.

In the context of the latter, the OECD has just published its latest Economic Outlook. As one would expect from the two speed nature of the world economy, significantly higher growth is forecast from the major non OECD economies, mostly, of course, the BRIC economies. Brazil is forecast to grow by 4.1% this year and 4.5% next year, the Russian Federation by 4.9% this year and 4.5% next year, India by 8.5% this year and 8.6% next year and, finally, the largest of all the BRIC economies, China, where growth is forecast at 9.0% this year and 9.2% next year. The closest that any of the G7 economies gets to the lowest of the BRIC's growth forecast for this year is Germany at 3.4% and Canada at 3.0%, whilst the closest forecast for next year is the USA where growth is forecast at 3.1%. Japan, having performed well in 2010, with economic growth at 4.0%, is forecast, as a result of March's earthquake and tsunami, to show a contraction of 0.9%, but the situation is expected to be even worse for the most troubled eurozone economies. Greece is forecast to contract by 2.9% this year and Portugal by 2.1%. Ireland is expected to be flat. Of the G7 economies not mentioned above, growth of 2.6% is expected this year in the USA and 3.1% next year, as mentioned above. The UK is forecast to grow by 1.4% this year and 1.8% next year. France's growth forecast for this year is 2.2% and 2.1% next year, whilst Italy, a very heavily indebted country as far as outstanding public debt in relation to GDP is concerned, is only expected to grow slowly at 1.1% this year and 1.6% next year. But the importance of the BRICs and other developing and emerging markets is growing. Last October, the IMF estimated that, on a purchasing power parity basis, which is an estimate of what currencies should stand at against each other, based on each currency's purchasing power, emerging and developing countries represented 46.2% of world GDP. So, whilst a number of major industrialised countries can contemplate low growth, their influence on the outcome of world economic growth is decreasing in importance. Given the global spread of many western and Japanese companies, it is possible to obtain low risk indirect exposure to these economies, so a negative view of domestic equity and certain bond markets cannot always be justified. The impressive profits performance which many companies in the USA and Western Europe are showing is testament to this fact.

Low growth industrialised countries are often struggling under the burden of debt, both public and private, and, as we have seen in parts of the eurozone, the issue has to be addressed, otherwise it risks spiralling out of control, as has happened in parts of the eurozone. The issue of debt has sparked an intense debate as to how it should be addressed and at what pace. We have discussed in detail one area where it is a problem, the eurozone, and seen how a monetary union provides no protection for countries which do not keep their borrowing under control. In the UK, there is a debate raging about how fast the structural deficit elimination programme should proceed. On the one hand, the government believes that a robust approach to eliminating the structural deficit is vital whilst the Opposition advocates a more measured approach. From where we see it, the government does not have much choice but to do what it plans. Unlike the USA, the UK's currency is not a major reserve currency.

Foreign investors do not need to hold it and therefore it is particularly vulnerable to a change in sentiment. What could change sentiment is a belief that the government's resolve to tackle the structural deficit problem has weakened. The UK has received its down payment on its robust policy with a relatively strong performance from the UK bond market since the last General Election and confirmation of the UK's AAA sovereign debt status which could have been in doubt had the deficit not been tackled. Whilst, theoretically, one can see the argument for a slowdown in the deficit reduction programme to support the UK economy which is going through a weak patch, in practical terms it is highly dangerous. That is because UK government bonds, like others, look expensive. They have priced in the benefits of deficit reduction and there is no room for disappointment. If one is a substantial debtor like the UK government, one's freedom of manoeuvre is limited and, if the UK's creditors take fright at a relaxation in policy, gilt yields could soar and the pound fall. The country would be at the mercy of its creditors. Whilst not nearly as severe a case as Greece, we did note moves by some of the strongest eurozone members to try to control the Greek privatisation programme. Those arguing for a slowdown in the deficit reduction programme ignore the market risk. The UK's borrowing levels remain frightening. Although it has not reached that level, it is estimated that if the level of public debt as a percentage of GDP exceeds around 90%, such a level has a permanent effect on a country's economic growth potential. In the current year, the Office for Budget Responsibility forecasts that public sector borrowing will be £122 billion, lower than last year because of the measures taken, but a frightening figure.

For Japan, the issue is different. Very high levels of gross and net public debt as a percentage of GDP (gross debt stands at over 200%) would normally be a very dangerous level and still could be in due course. For the moment, however, the fact that most of this debt is held domestically means that Japan is not vulnerable to a loss of confidence on the part of foreign investors and, as another measure of economic strength, Japan normally runs a current account surplus and has the second largest foreign exchange reserves after China. Japan will have to address the problem with its public finances but, for the moment, in the aftermath of last March's earthquake and tsunami and the diversion of interest caused by the problems elsewhere, it is not one of the main issues for investors' attention.

For different reasons, the USA is in a similar position of not being a major focus of attention for its debt problems when, in other circumstances, it may have been the major focus of attention. Although many have raised the alarm bells about the path of the USA's budget deficit and level of outstanding public debt, there seems to be no desire amongst the warring parties in Congress and the Administration to make decisive inroads into the problem. Arguments about the balance between tax cuts and tax increases still rage and the approach of next year's Presidential election does not encourage many politicians to talk about the issue now. So, we can only repeat what we have said many times before, that, if the USA does not address its public finance problems decisively and soon, it will have a real problem, probably manifesting itself in a very weak currency and rising interest rates.

Of course, not all currencies can go down at the same time. So, even though the euro, sterling, US dollar and yen have reasons why they might be weak, all things are relative, so some will strengthen against the others, simply because their country's predicament is not felt to be as serious as the others' predicament. Meanwhile, the currency with no real problems (apart from the effect of its strength on some Swiss companies), is the Swiss Franc, which has risen substantially in value over the quarter.

Commodity prices have been an issue for different reasons with some quite violent movements recently giving rise to anxiety about the level of speculative positions. For example, between 28 April and 6 May, silver fell by over 27%. There was, and still is, a concern about the oil price after the military intervention in Libya. Taking Brent crude, the spot price rose to US$128.04 a barrel in April after the military intervention, a rise from the end of last year of over 34%, although it has since fallen back in price to be nearly 22% higher. As this is written, the situation in North Africa and parts of the Middle East seems slightly calmer (this is a relative term) and worries about the oil price have temporarily subsided, although from a very elevated level, so that there cannot be any room for complacency. In so far as commodity prices rise, there is a transfer of purchasing power from consumers to producers and, in many cases, the additional money cannot be spent quickly if, indeed, the commodity producers want to spend it at all. There is a tendency amongst officials to emphasise the core rates of inflation in their particular countries, rather than the overall rate, or at least to use the core rate as the yardstick for policy. The core rate excludes volatile items like food and energy, but people's inflation expectations, an important indicator for interest rate setters, will certainly be influenced by the overall level of inflation and commodity price rises will fuel their way into the general price level. Many companies in the consumer staples sector are referring to the pressure of input costs. Given the high level of margins being demonstrated by many companies, for example, in US companies' first quarter results, investors can have a reasonable level of confidence that the situation is manageable although there is no room for complacency. Nevertheless, the extraordinary combination of recent national disasters and political unrest is important in acting as a reminder of the delicate balance of factors affecting investment. An important support for commodity prices (and also financial assets) has been the very loose monetary policy followed by many leading countries in the aftermath of the financial crisis of 2008 and 2009.

The absence of any meaningful yield on deposits and the printing of money through the quantitative easing programmes which have been followed, have distorted markets, pushing money into assets which might offer a better return. It has also caused problems for developing and emerging markets as money has flowed into them in search of higher returns. One unwelcome effect for these countries, Brazil is a prime example and some Asian countries another, is that their exchange rates have been pushed higher, rendering their economies less competitive. At the same time, capital inflows threaten bubble conditions and the bursting of bubbles can have unpleasant consequences. Some countries, Brazil and Thailand, for example, have erected barriers to try to ward off speculative capital inflows.

It looks, however, as if monetary conditions in the USA, UK, the eurozone and Japan are going to remain very loose, at least on the interest rate front, although the end of QE2 in the USA will put a brake on a further loosening of policy. As we noted from the latest OECD economic forecasts detailed earlier on in this review, most of the leading industrialised countries are expected to experience only modest economic growth, so that a tightening of monetary policy through interest rate increases at a time when, in many of these countries, fiscal policy is restrictive, could be counterproductive because monetary policy needs to provide an offsetting stimulus. Even the most hawkish central bank, the ECB, which has started to raise interest rates by a modest 25 basis points, is unlikely to proceed too quickly with returning interest rates to a more normal level. The two obvious dangers are the distortion of the asset and currency markets, as mentioned above, and the inflationary threat arising from negative real interest rates. For the moment, however, these concerns take second place to the need to provide a stimulus to the economy. Whilst this situation prevails, investors in certain asset classes are likely to continue to benefit from the diversion of cash seeking higher returns. This, however, is not a high quality reason for rising asset prices, though they may, of course, be combined with better reasons for asset price strength.

Turning to industrial countries and regions, we start with the USA where official figures confirmed that the US economy grew at an annualised rate of 1.8% in the first quarter of the year. Although there was no revision to the overall estimate, the make up of the increase was changed. The Bureau of Economic Analysis reported that consumer spending grew at an annualised rate of 2.2% in the first quarter, instead of the first estimate of 2.7%. On the other hand, business investment in buildings and inventories increased, although the latter will reach an equilibrium after which it will not be able to support further growth. However, perhaps the most interesting information in the past month came from the latest FOMC minutes, which highlighted a discussion on the possible strategies for exiting quantitative easing. This has got to happen at some stage as the Federal Reserve's balance sheet is shrunk. The printing of money will ultimately lead to inflation if the policy is not reversed. At its most basic, the money printed must be withdrawn from the economy and this was the basis of the FOMC's discussion.

The first part of the plan is to confirm the ending of QE2 to which we referred earlier. The minutes, for the first time, said that the Federal Reserve planned to stop reinvesting the principal payments on its Treasury securities "simultaneously or soon after" it stopped mortgage backed securities reinvestments. The minutes went on to say that a "majority" in the committee wanted to start mortgage backed securities sales after the Federal Reserve had started to raise interest rates. The majority also favoured outlining a plan and path for pre-determined sales of these securities. In other words, it could be the mirror image of the issuing plans announced for quantitative easing but, this time, in reverse. However, this discussion came without any dates or time horizon and was more about the mechanisms of the plan. There were mixed opinions amongst the FOMC members as to when all this might happen, but the ending of quantitative easing is the first step along the path to reversal. However, nothing in the minutes suggested that they would not react further if the US economy weakened. Nevertheless, the debate, as reported in the minutes is significant.

As the estimate of first quarter GDP growth shows, progress for the US economy is something of a struggle at present and this despite the very loose monetary policy being followed. As elsewhere, sharply rising oil prices are deflecting purchasing power from consumers to producers. A rising trade deficit in March shows the problem with growth in exports, 4.6% in March, being overcome by the need to import more expensive oil with the result that net trade is not adding to overall growth. Another drag on growth is the housing market. For example, in April, new homes construction fell by 10.6% as the market continues to suffer from a supply overhang. The good news for investors is that US corporate earnings surprised on the upside in the first quarter with margins at very high levels. Rising import costs are providing a headwind but the low value of the US dollar is making the USA's exports highly competitive and we have seen some excellent results from US manufacturing companies.

Currency movements are very hard to forecast in the short term. With some of the stronger economies raising interest rates in an attempt to rein in inflation, Australia being a good example, the carry trade is attractive to some speculators because they can borrow cheaply in all the currencies where the issuer has economic problems, i.e. the USA, UK, eurozone and Japan. Of course, this is a dangerous game if the unexpected occurs in the foreign exchange market. However, because we know that, at some stage, the USA is going to run into trouble because of its spiralling deficit, it is likely that the US dollar will experience weakness. In that case, one of the better ways for investors to position themselves would be in US companies with large overseas business, as their enhanced profitability should provide some offset to currency weakness. Of course, this is not only the USA that will be affected, it is other companies in different countries or regions where the same may apply, i.e. the UK, eurozone and Japan. This is a very simple analysis which could be overtaken by other events but, in these extraordinary times when we have ultra low interest rates, money being printed in some countries and distorted exchange rates, good quality US companies (and those elsewhere) offer some attractions, especially when modestly rated.

In front of the November 2012 Presidential election, it would be optimistic to expect action on the US deficit unless the market forces it. Investors have to be wary of this, but, for the moment, we think they can be sanguine about prospects for the US equity market. For bonds, as elsewhere, we think that the story is different. It is difficult to see any value in US Treasuries. Yields look unappealing, a crisis surrounding the deficit is always possible and the funding needs are enormous. The end of QE2 will remove a big purchaser of Treasuries from the market and, later on, as discussed earlier, the Federal Reserve will be a seller of Treasuries. If a truly catastrophic situation emerges like, for example, the financial crisis of 2008, then a flight into Treasuries can be imagined and the turmoil in the eurozone's sovereign debt market could continue to benefit them but, in any of the more likely scenarios, US equities look the more attractive asset.

Of the many unenviable jobs for policy makers in the eurozone, one is that of the rate setting board of the ECB. Its remit is to keep inflation to a limit fractionally below 2%, but inflation now stands at 2.8%, so it has a problem which it started to address when it raised interest rates by 0.25% to 1.25% in April. The noises then were that there would be another increase in June but that looks as if it has been put back, perhaps to July. It is the most orthodox of the central banks and clearly finds the present situation very difficult. Inflationary pressures are quite apparent in the eurozone. Producer price inflation in March was 6.7% year on year, having risen 0.7% alone in March. March's consumer price inflation was 1.4%, followed by 0.8% in April, which are uncomfortable figures. Core inflation accelerated sharply in April, rising by 1.8% year on year against 1.5% the previous week. In isolation, these inflation levels would cause the ECB to act quickly to raise interest rates sharply but they have a host of other issues to concern them which they would not normally be obliged to consider. If interest rates start to rise, problems will mount for the troubled eurozone economies. Given the amount of eurozone bonds, particularly Greek government ones, which the ECB has bought to provide liquidity to the market, rising default concerns will impact the ECB itself. This explains its hard line on restructuring even though it is quite clear that Greece, Portugal and Ireland and, possibly, others, will have great difficulty repaying their debt in full, and that is being highly optimistic. The cross border exposure of the eurozone's banks to each other's debt is a major concern for the ECB, which is why everyone concerned wants to keep the show on the road as far as the eurozone is concerned. Our view, which we have often stated in these reviews, is that the eurozone will fragment and the fear of this happening will continue to affect the euro.

But it is not all bad news from the eurozone. First quarter GDP is estimated to have grown by 0.8% after 0.3% in the final quarter of 2010. The weakness of the euro has helped the competitiveness of eurozone countries and we have seen decent first quarter growth from France and Germany with outcomes of 1.0% and 1.5% respectively. In the case of Germany, this lifts activity back to over its previous 2008 peak. There are, however, signs of slower activity in the second quarter, at least on the figures announced so far. The overall level of activity, as measured by the purchasing managers' index for the eurozone in May, seems to have slowed down. The overall index fell from 57.8 in April to 55.4 in May. Within the overall index, France's outcome was 60.5 in May against 62.4 in April whilst that for Germany was 56.4 against 59.9. Any figure over 50 implies expansion so the readings in April signify a slowdown in the rate of growth rather than contraction even though the fall in the absolute level of the index was quite sharp. Also, the European Commission's business and consumer optimism survey shows a decline in the main sentiment indicator from 106.2 to 105.5, its third consecutive fall. The current experience of the eurozone is that, notwithstanding all the sovereign debt problems which it is currently facing, the profile of the world economy, showing good growth in certain parts of the world, is providing opportunities for companies and, therefore, the economies in which they are based. With many companies performing well and shares of many eurozone economies very modestly rated, the problems of the euro should not deter investors from being significantly invested in the eurozone.

Earlier we touched upon the remarkable performance of the Swiss Franc, which is seen as a safe haven in these troubled times for currencies. Switzerland seems everything in terms of stability which the eurozone is not. It is a two edged sword for Swiss companies because, whilst the financial and economic attraction of Switzerland is obvious to investors, encouraging a flow of funds into the country, it makes life harder for Swiss companies which export and those which have substantial overseas business (the large ones) suffer a currency translation disadvantage on their overseas earnings. But, after underperformance in the first quarter of the year, there has been a relative recovery in Swiss stocks recently and, as the table at the beginning of this review shows, foreign investors in Swiss stocks have enjoyed a strong quarterly return.

The performance of the Japanese equity market has, naturally, been affected in the short term by the terrible events of March. That, however, is not a reason to take a fundamentally different medium and long term view of Japan and, prior to March, foreign investors had been putting money into the country. Japanese GDP data tends to be revised substantially, but the preliminary estimate of first quarter GDP was for a quarter on quarter decline to the end of March of 0.9% and this followed from a downward revision of the previous quarter's growth to -0.8% compared with the initial estimate of -0.3%. At this early post earthquake and tsunami stage, one has to take a view on the effect of the events of March on the Japanese economy. Leaving aside the important nuclear power and energy source issue, which we can already see having consequences elsewhere, notably Germany, where the government has just announced plans to dispense with nuclear power, the effect on supply chains will be important. With increasing globalisation, supply chains have become increasingly interdependent, so that a car made in the USA or UK may depend for some components on a Japanese supply source. Pressures to become as efficient as possible include minimising working capital requirements so that "just in time" ordering of components has often become the norm. Now, as one writer put it, will some companies move to a "just in case" situation whereby increased stocks may be held, meaning more money tied up in working capital, or, will they switch some components supplied from Japan to countries outside an earthquake belt? In Japan's favour is the high quality of its manufactured products and rebuilt production facilities will obviously take into account the earthquake and tsunami. We will have to wait and see if companies worldwide show any behavioural changes relating to supply chains but, if we had to guess, it would be that the Japanese reputation for high quality manufactured products will see them avoid too many supply chain consequences. Interestingly, and quite separately, on the subject of inflation, Japanese consumer prices rose by 0.3% in April, reflecting higher utility bills and petrol prices. It is early days, but, if the deflationary psychology in Japan can be changed, it could change the attitude of consumers towards consumption. If expectations of deflation prevail, then there is every incentive to hold off non essential purchases. If expectations change, consumer spending could increase and help economic growth. At this stage, we do not think that investors should change their stance on Japan unless and until there are any definite indications of negative medium and long term consequences for the Japanese economy.

For China, the major economic issue is inflation, and all policy makers' efforts are focused on this problem. The latest consumer price inflation figures for April show the year on year figure to be 5.3%, down slightly from March's 5.4% level. The worrying figure remains the 11.5% year on year increase in food prices. Food prices make the authorities nervous because of their potential for causing unrest. Strenuous efforts have been made by China to get on top of the inflation problem. Since last October, interest rates have been increased four times and bank reserve requirements raised eight times to rein in liquidity. Whilst such a policy could be expected to bear down on domestically generated inflation levels, food price inflation is not normally driven, to any great extent, by monetary conditions. Weather is an obvious driver of food prices, quite independent of other factors. It is probable that, provided China is not subject to outside pressures, as has been the case from time to time, it will let its currency rise towards more realistic levels, even though its real exchange rate is rising as the country experiences relatively high inflation levels. However, all things are relative and the latest OECD economic growth estimates for China this year and next, at 9.6% and 9.2% respectively, put things into perspective. In all sorts of ways, China, not to mention India and Brazil and many other fast growing economies, will increase their influence on the world economy. In very basic terms, the way for investors to react to this is with exposure to these countries' stock markets, either directly or indirectly, through companies or countries (i.e. Australia) which will benefit. It is, of course, more nuanced than this, but the general principle is correct.

Although the UK equity market fractionally outperformed the FTSE World Index in the latest quarter, the economy is struggling at present, giving ammunition to critics who say that the government should move less slowly in its efforts to eliminate the country's structural deficit by the end of this parliament. As we have said, we believe this latter course of action would leave the UK at the mercy of markets which are in a mood to punish some, but not all, recalcitrant governments which are not presenting a convincing plan to put their countries' finances into good order.

The second estimate of first quarter GDP confirmed growth at 0.5%, thus pretty well reversing the weather affected 0.5% contraction in the fourth quarter of 2010. Although the overall growth figure was confirmed by the ONS, its make up altered from that given in the first estimate. Household spending fell by 0.6% during the quarter and business spending was flat. Trade and government spending were positive drivers of growth, although the latter effect will die away as the deficit elimination policy bites. The news on inflation is not good either, with the unexpectedly good figure of 4.0% for March giving way to the unexpectedly bad figure of 4.5% in April. All things are relative, for both of the figures are well above the 2.0% Bank of England target. Special factors had something to do with the unexpectedly poor figure for April. In his letter to the Chancellor of the Exchequer, which he is bound to write because the inflation figure is so far above the target level, the Governor of the Bank of England said that he expected inflation to rise further in the next few months because of rises in utility and energy prices but, thereafter, to fall back towards the target. Core inflation, at 3.7% in April, was at its highest level since records began in 1997.

There is, therefore, a real dilemma for the Monetary Policy Committee of the Bank of England as it sets interest rates. Under the impact of a tough fiscal policy, there is a case for keeping monetary policy very loose as an offset. However, the inflation bells should be ringing alarmingly. The Bank of England has consistently underestimated the inflation threat and negative real interest rates, particularly at the current level, would normally sound a major alarm on the inflationary front, which such a policy poses. The Bank of England's quarterly report, published in May, was quite downbeat. It indicated that consumer price inflation could reach 5% this year (the previously used Retail Price Index is above that level). Its medium term growth rate forecast for the UK economy has been scaled back from 3.1% to 2.8% annual growth rate.

It goes without saying that this will be a particularly difficult year for UK policymakers, both in the government and in the Bank of England. We think it correct to say that there is really no alternative for maintaining the credibility of policy which, for the UK's creditors, is of paramount importance. This does not mean that the UK stock market will perform badly. A significant majority of the activities of major UK companies derive from overseas and in markets which are growing strongly. UK companies should continue to benefit, as will be seen in the growth in corporate earnings and dividends, and the modest earnings multiple of the UK market, as for many others in Europe, confirms to us the value there. Because of all the bad news in the background, we continue to believe that market progress will be uneven, meaning some negative quarters against the background of a general upward trend in equity prices on the back of growth in corporate earnings and dividends and in the context of a loose monetary policy being pursued in many countries. Bonds continue to have yields artificially depressed by monetary policy and, to us, it is difficult to see value with such low yields against the background of rising inflation, heavy government borrowing and an ultra loose monetary policy which will have to be reversed at some stage in those countries involved in quantitative easing.

Notice to readers:

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 May 2011