meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Following an uncertain start to the year, international equity markets made an impressive recovery this quarter with our table of performances below showing no areas of negative performance. No new developments have occurred to influence markets, rather it is the "bottle half full" feeling which has prevailed over the earlier "bottle half empty" view of the world. There was not too much change in international bond markets but, in the foreign exchange market, sterling recovered some ground. In commodities, oil recovered impressively, albeit from very low levels.

The tables below detail relevant movements in markets :

International Equities 29.02.16 - 31.05.16

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+11.7	+8.5	+13.3	+10.6
Finland	+3.1	+1.1	+5.6	+3.1
France	+5.9	+3.9	+8.5	+5.9
Germany	+8.1	+6.0	+10.8	+8.1
Hong Kong, China	+9.4	+4.9	+9.5	+6.9
Italy	+5.3	+3.3	+7.8	+5.3
Japan	+7.1	+4.3	+9.0	+6.4
Netherlands	+6.9	+4.9	+9.5	+6.9
Spain	+8.3	+6.3	+11.0	+8.3
Switzerland	+7.5	+3.1	+7.7	+5.1
UK	+3.8	+3.8	+8.4	+5.8
USA	+9.4	+4.7	+9.4	+6.8
Europe ex UK	+6.9	+4.4	+9.0	+6.4
All World Asia Pacific ex Japan	+7.4	+5.4	+10.0	+7.4
All World Asia Pacific	+7.3	+5.0	+9.6	+7.0
All World Latin America	+8.5	+9.1	+14.0	+11.2
All World All Emerging	+8.8	+5.7	+10.3	+7.7
All World	+8.2	+4.6	+9.2	+6.6

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +0.4%

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

Currency	29.02.16	31.05.16
Sterling	1.46	1.56
US Dollar	1.74	1.84
Yen	-0.06	-0.12
Germany (Euro)	0.11	0.14

Sterling's performance during the quarter ending 31.05.16 (%)

Currency	Quarter Ending 31.05.16
US Dollar	+4.3
Canadian Dollar	+1.0
Yen	+2.2
Euro	+1.9
Swiss Franc	+4.0
Australian Dollar	+3.1

Other currency movements during the quarter ending 31.05.16 (%)

Currency	Quarter Ending 31.05.16
US Dollar / Canadian Dollar	-3.2
US Dollar / Yen	-2.0
US Dollar / Euro	-2.4
Swiss Franc / Euro	-2.0
Euro / Yen	+0.4

Significant Commodities (US dollar terms) 29.02.16 - 31.05.16 (%)

Currency	Quarter Ending 31.05.16
Oil	+38.7
Gold	-1.8

MARKETS

It has been a very solid quarter for international equity markets as they recover from stock market jitters in the early weeks of 2016. In sterling terms, the total return on the FTSE All World net of tax index was +4.6%, in US dollar terms it was +9.2% and in euro terms it was +6.6%. Looking at local currency returns first, the local currency returns were fairly closely bunched. The top performer in our table was Australia where the FTSE Australia index returned +11.7%. The UK was one of the lowest performers with the FTSE UK index returning +3.8%, still a very good quarterly return. In sterling adjusted terms, all areas showed a positive return with the FTSE UK Index return much closer to that of the FTSE All World Index because of the weakness of foreign currencies against sterling. The stand out performers in sterling terms were Latin America, where the FTSE All World Latin America index returned +9.1% and Australia where the return on the FTSE Australia index was +8.5%.

In the ten year government bond markets, movements were quite modest by recent standards. The gross redemption yield on the UK ten year government bond rose by 10 basis points to 1.56%, on the US Treasury bond by 10 basis points to 1.84% and on the German Bund by 3 basis points to 0.14%. On the other hand, and still quite extraordinary, the gross redemption yield on the ten year Japanese Government Bond fell by 3 basis points to -0.12%. It is truly an extraordinary state of affairs when an investor pays the government for the privilege of lending money to it.

In currency markets, sterling staged a partial recovery after recent weakness. Against the US dollar it rose by 4.3%, against the Swiss franc by 4.0%, against the Australian dollar by 3.1%, against the yen by 2.2%, against the euro by 1.9% and against the Canadian dollar by 1.0%.

In commodity markets, oil, as measured by Brent crude, staged a significant recovery, rising by 38.7%, whilst gold slipped back slightly by 1.8%.

ECONOMICS

The current forecast for world GDP growth in 2016 is, according to the IMF, 3.2%. This is not unhealthy but neither does it indicate an economy which is expanding strongly, especially given the tailwind provided by the world's leading central banks. To put this into context, growth in 2015 was 3.1% and 2014 was 3.4%. Comparing this with a decade earlier, growth in 2006 was 5.1%, 2005 4.9% and 2004, 5.3%.

It would be logical to expect economic growth around the world to be hit during a financial crisis and it would also follow that the reduction in the post-crisis growth rate immediately after would be proportionate to the size of the crisis - the deeper the hole, the harder it is to climb out. It would also seem logical that once that short, initial period of shock is over, growth rates would exceed previous levels as a period of catch-up takes place. Some years have passed since the depths of the crisis and a consistent aspect of the recovery has been that rates of growth have not reached pre-crisis levels of growth and, furthermore, there has been consistent over-estimation of anticipated growth over many years, which has been followed by downward subsequent revisions to those growth rates as time has passed. Indeed, it is also interesting to note the breadth of organisations that have initially over-stated their forecasts such as the IMF, OECD, Bank of England, the European Central Bank and the Federal Reserve in the United States amongst many others. There is no shortage of theories why there has not been a reversion to mean.

Using the IMF's World Economic Outlook figures, which are updated each spring and autumn, it is interesting to look at the pattern of revisions of the past few years. In the spring of 2009 the IMF forecast world GDP growth for 2011 and 2013 at 4.3% and 4.9%. These years eventually experienced growth of 3.9% and 3.3%. In the spring of 2012 IMF forecasts were for 4.4% for 2014 and 4.6% for 2016. Growth for 2014 was, in fact, 3.4% and the current forecast for this year is 3.2%. The pattern of optimism is reflected across their, and other agencies', forecasting and the causes of this underperformance have been attributed to various factors, such as under-investment by companies, a lack of productivity growth, austerity policies and austerity mentality and poor money supply and credit growth attributable to lending.

One of the conundrums of this period is that it was an excess of debt which created the financial crisis and yet the extraordinary lengths policymakers have gone to in order to stimulate demand have centred on the expansion of the money supply and credit growth through interest rates and quantitative easing. The simple action of printing money has followed the more traditional tool of cutting interest rates and central bankers turned to quantitative easing once the interest rate cutting lever had been pulled and was reaching its limit. The two aspects of that policy are encouraging holders of cash to spend it (effectively) and encouraging the credit-worthy to borrow and spend, both outcomes leading to economic activity that, through the multiplier effect, creates self-sustaining economic growth. Banks have sold assets to their central banks which has made cash available for lending. Short term interest rates have been reduced to the point that the banks' clients are heavily incentivised to borrow and discouraged from depositing. It is difficult to forget that the financial crisis was a banking crisis that was brought about by lending, where banks' stretched balance sheets were suddenly exposed and where liquidity dried up in key funding markets where the deposits that banks needed were provided through securitisations. One positive of the current period is that the certainty of banks getting their funding from their central bank provides more reassurance than a dependence on the securitisation markets. One significant difference between the current situation and the one of a decade ago is that at the centre of the crisis was a culture of banks that were lending in an over-competitive way, obsessing over market share in the lending market and lending irresponsibly to customers who had little chance of repaying their loans. These loans were packaged up into investment vehicles and sold as a lower credit risk than was in fact the case. The overall result was the money was being lent by banks not assessing the true credit risk, to customers who were not credit-worthy and the resulting asset-backed securities were bought by investors who were unaware of the true nature of the underlying investments. The outcome had been driven by the expansion of asset values over the expansion of the economy, though the effect on economic growth was positive numerically if not in terms of the quality of the growth.

The contribution banks made to the crisis is well documented and the reckless lending that, for example, Irish banks wrought on their economy is still being felt. Ireland in the first decade of this century was a country where there was an excess of 'animal spirits', an unusually high level of direct foreign investment and an artificially low interest rate. There was little effort to rein in the excesses of the time until it was far too late.

Much has changed in the world of banking and banks are now capitalised to a far higher level than ever before, they are far more cautious in their lending practices and they are regulated far more tightly. They also find themselves in the contradictory position of being told by policy makers to lend more, but simultaneously to de-risk and to reduce the size of their balance sheets.

A simple conclusion from the 'then and now' is that the act of lending is neither a risk-free activity nor is it automatically synonymous with systemic risk but rather the risk to which the economy is exposed is a function of the quality of lending. Current policy seeks to remove all possible barriers from the decision-making of borrowing whilst ensuring that banks act responsibly through a combination of internal disciplines and regulation. Interest rates hover around historic lows and the prospect of their remaining below long term averages is something to which everyone is becoming accustomed. Both short term rates and long term rates are attractive and in some economic areas, such as the EU, banks are being paid to lend money to small and mid-sized corporates. Whom the money is being lent to here is a key detail. Announced in March, European high street banks can borrow cash for free for up to four years from the European Central Bank (TLTROs - Targeted Longer Term Refinancing Operations) but if that money is lent onwards to corporates then the ECB money is accompanied with a negative interest rate. There are very few further steps that central bankers can take in this area. It reaches the point that the propensity to borrow money is not governed by the cost of borrowing but rather by other factors, such as the perceived lack of worthy projects or a reluctance to increase gearing further. Another consequence of market rates being pulled ever further downwards is that net interest income, the measure of the profitability of a bank's lending after the costs of paying its depositors interest, is squeezed as the former falls but it is often not possible to charge clients for their deposits through negative interest rates for fear of alienating them or attracting criticism.

Looking solely at the United Kingdom, the household savings rate is currently around 4%. It was last at this level in the mid-60s, before rising to over 15% by the end of the 70s. A drop in the savings rate would normally be interpreted as a fall in household income or a rise in household expenditure or some combination of the two. To what extent the reward for saving, the interest rate, determines the aggregate level of saving is not known but it is likely to be overshadowed by these two determinants as well as a sensitivity to fear as shown in 2008-09 when the savings rate jumped from around 5% to 12% despite cuts in interest rates. The fall in the savings rate from that point to the current level has been consistent.

One country which has been affected even more greatly than Ireland is, of course, Greece. With the UK referendum and a general election in Spain in June great care has been taken to manage Europe's position quite carefully, but, in May, it was announced that agreement had been reached between the Eurogroup, the IMF and Greece. There is little value in saying it but Greece is bankrupt. It would not be able to sustain its debt position in the open market if it were not supported by the European Union, the IMF and the ECB, all of whom are lending to Greece not through choice, but because of the risks of not doing so. Greece currently has a level of indebtedness of 175% of its GDP which is approaching double the level of debt which the British economy carries. Translating Greece's debt position to the man in the street, its income has dropped over the past years and it can't afford the mortgage. It has slipped further and further into arrears, worsening the position and, with the threat of the bank foreclosing on the mortgage, a wealthy friend has offered to re-finance the mortgage at favourable rates. The householder, who remains heavily in debt, is no longer threatened by the immediacy of the problem as the friend has cut the repayments and said the loan does not have to be paid off for some decades. What can be seen now, and the IMF has brought this back to centre stage this month, is that the crisis has not been averted but, at best, it has been diluted and the secondary effects of the action need to be considered. The central issue is whether enough has been done to allow Greece's economy to start growing and, over time, move consistently back towards solvency. The IMF's answer is an unambiguous 'no' and so falls foul of its sustainable debt policies which cover its lending to countries in difficulty. The second more academic, but equally important, question is how did the country get to be in this position and what needs to be done to prevent such an economic collapse from happening again elsewhere?

The IMF's position, driven by economic imperative more than political pragmatism, is that European creditors forego any Greek debt repayments until 2040 and fix interest rates on the debt at 1.5% over that time. The IMF, being a global body and a creditor in the arrangement owning 5% of Greece's debt, is under pressure from its members around the world to ensure that it follows its own rules on debt sustainability and doesn't get drawn into a position from which it can't escape. Its strong preference is that the EU buys back some of the debt owed to the IMF, something that would ease the pressure on the IMF but doesn't necessarily improve the whole picture. Germany is particularly reluctant to go down the route of debt write off, fearing a voter backlash at home and moral hazard abroad, in other E.U. countries.

Under the current bailout programme an assumption has been made on the growth rate that Greece will achieve and this is an important factor in understanding whether the sums add up. The primary surplus target for the country is currently 3.5% per annum for the next five years which is, by most measures, a very high figure. This is a country which has little room for fiscal manoeuvring, cannot stimulate its economy through borrowing, has an exhausted population after years of austerity, has an unemployment rate of 24.4%, is on the front line of an unprecedented migration crisis and is subject to strikes by its disaffected populus. A growth rate of 3.5% per annum would make it the best performing economy in Europe but it is likely that it will fall short of this rate, possibly by some margin.

In the lending markets, like any other, non-market pricing represents a discount to one side of the trade and a cost to the other. In this case it is clear that Greece is being subsidised for a variety of reasons but the cost to the lender(s) is just that - a cost. The participation in the debt is spread proportionately across the eurozone member countries which means that some, if not most, have their own financial constraints which need to be balanced against the cost of supporting a fellow E.U. nation in difficulty. As the election cycle continues across Europe, historic voting patterns are being disrupted by a wide variety of issues and it is not just in the U.K. where views on the E.U. are increasingly polarised. Any deterioration in the situation between Greece and its creditors is likely to contribute negatively towards the increasingly fractious debate on Europe in Europe. On the 24th May, it was announced that following Greece's parliament's decision to adopt further belt tightening, such as raising VAT to 24% from 23%, the E.U. would provide more emergency funding and the IMF re-joined the funding exercise following a difficult period when it and the Eurogroup finance ministers disagreed over how to resolve the fundamental issue that Greece's debt pile is just too large for it to deal with. Details at this stage are thin on the ground but the €10.3bn. of new loans were welcomed in Athens and some definition is awaited on the possibility of debt relief in 2018.

Returning to the question posed earlier in the memorandum on how Greece got to this stage it is necessary to look at its recent economic history. Greece joined the E.U. in 1981 and enjoyed very little economic growth in that decade; GDP grew by around 10% over the whole decade. Greece then experienced a prolonged period of economic growth of around 62% between 1994 and 2007. Two characteristics of the period that are remote from today's conditions in Europe were the level of inflation and the expansion of the economy through borrowing. At no time in the twenty years before 1994 was inflation in Greece below 10% and the average rate was above 15%. Over the same 20 years debt as a share of GDP rose from below 25% to almost 100%. On the eve of its entry into the eurozone in 1992 the nominal interest rate on long term Greek government bonds was over 24% per annum. At the same point France's equivalent debt paid around 8½% and Germany's debt 7¾%. Investors demanded to be compensated for the risk of investing in drachma, which meant high inflation and higher default risks. In the decade after 1992 inflation in Greece fell sharply as the government worked hard to cut its deficit and, by the end of the century, Greece could achieve the Maastricht convergence criteria to join the euro. These criteria were designed to ensure that countries were similar enough to adopt the single currency by referencing that country's deficit and debt level, inflation rate, exchange rate stability and long term interest rate.

The two countries discussed so far, Ireland and Greece, have been close to the epicentre of the financial crisis and it is clear that the routes to their respective nadirs were quite different, though both found themselves in positions where the State was obliged to seek a bailout. In Ireland's case an ill-fitting interest rate and rigid currency intensified the boom time sentiment in the country and, in Greece's case, the depths of its financial position were obscured by credit markets that were mis-pricing the credit risk and government data on its deficit that it later admitted were falsified; a key motivation at the time had been a push to achieve the Maastricht convergence criteria, above everything else.

For a short period of time in the last decade Ireland could borrow money on the open market at a lower rate than Germany. It seems strange now and is indicative of the false market at that time. Equally, Greece profited from a borrowing rate that did not reflect the true risks of lending to the country as euro borrowing rates harmonised. What then looked like part of the plan now looks like part of the problem. Fast forwarding to 2016 and spreads between low risk member states and higher risk member states are more realistic, though aside from Greece, which is in a category of one, having a gross redemption yield on its 10 year bonds of around 7%, other higher risk countries can still borrow for 10 years at historically low rates - Portugal at 3%, Italy at 1.4% and Ireland at 0.8%.The optimist would argue that these risks were tested by the financial crisis and passed as nobody suffered any losses but these rates still look incredibly low given the very wide range of potential developments in the next ten years. It is likely that, if these countries had their own national floating rate currencies and independent central banks, a period of devaluation would have taken place and domestic interest rates would be much higher, to attract foreign capital. A function of currency devaluation is usually an improvement in the country's current account deficit as exports become more attractive, relative to imports. In 2008, Greece's current account deficit was 14%, an indicator that its relationship with its trading partners was skewed towards importing as it had an exchange rate that was too strong for its economy. Today, many struggling European countries are benefiting from such low borrowing rates as interest servicing forms a smaller part of government revenues but the benefit to those countries is contrasted by, in our opinion, an under-pricing of the risks involved to the bond holders. Interest rate one-size-fits-all still exists. The ability of a country to devalue is limited when its currency is shared with eighteen other countries and, inevitably, the shared currency is most likely to move to support the economic pressures of the largest countries. Given that it is some of the smallest countries that have the most atypical economies in the eurozone, the pressures that come to bear on those peripheral states will be the most significant in times of stress. Either a foreign exchange rate will move to reflect changes to relative demand for the goods, services and other cash flows of trading economies or one of those economies will have to change its economy to suit the ill-fitting exchange rate which it is given. In the case of Ireland an already flourishing economy in the 1990s 'enjoyed' a halving of interest rates in 1999 when the euro was adopted. Foreign investment was recycled through bank lending and the boom times led to an influx of workers. With money having a far lower price, borrowing increased, leading to a giddying rise in property prices as well as a broader rise in inflation. Where a country has its own free floating currency its central bank would normally choose to raise interest rates to disfavour borrowing and put a brake on the expansion of the money supply.

In a system which is common across disparate member economies, the flow controllers and pressure release valves of interest rates and exchange rates are set incorrectly for idiosyncratic economies, which will only be exaggerated in certain phases of the economic cycle as any movements will not be tailored to that individual country, and this will inevitably sponsor undue pressures in the system. The patterns of behaviour that led Ireland and Greece to suffer such economic damage after 2008 were rooted before the arrival of the euro but the years after its adoption created a false market in those countries' debt, both in terms of prevailing interest rates and assessment of credit risk, leading to a deeper crisis than may have occurred otherwise.

It is only a few weeks now until we reach the halfway point of 2016 and it is instructive to consider how this first part of the year has panned out against the forecasts of six months ago. The rule associated with forecasting seems to be that the more important the subject matter, the more difficult it is to forecast accurately; in this respect examples such as the weather, earthquakes and economics, amongst others, spring to mind!

As at the end of May the FTSE All-World equity index shows a return of 3.2% in sterling terms. At the beginning of the year we warned of markets grinding higher with episodes of high volatility and this is something we saw in February. The principal potential drivers for such volatility could be seen as a key issue in each of the main economies - increasing growing pains in the Chinese economy, Japan's frustrating inability to kick start its economy, rising U.S. interest rates, the potential for Greece to remind us of the levels of indebtedness in Europe and, of course, the EU referendum. In the main, volatility, until now, has been lower than had been anticipated with China's central powers continuing to demonstrate that they remain totally committed to keeping the project moving forward, Japan slowing without it looking like a global threat, hard decisions about Greece being deferred (again) and markets seeming more comfortable with a 'remain' vote than a 'leave' vote. This is not necessarily on the basis of what is best for the long term future of the country but perhaps because Brexit would inevitably be very disruptive to asset pricing in the short to medium term. Current polling (for what it's worth!), seems to be indicating that the 'remain' vote will win but polling proved accurate eighteen months ago in the Scottish referendum and inaccurate in the general election last year.

The other significant event that is coming up is the Federal Reserve's decision on interest rates. There is an infinitesimally small chance it will cut and a fair chance it will keep rates the same but, increasingly, there is speculation that the U.S. will see its second rate rise in the last six months, which, if it happens, should not be viewed as a negative policy decision but, rather, the best chance of avoiding any shocks to the global system is that the process of rate normalisation is spread over the longest period possible. There is only one way interest rates can go from the current position - but this is a forecast that we have been saying for some years and have had to revise our forecasts on a regular basis - which only highlights how difficult forecasting can be! Whilst predicting the timing of interest rate rises is very difficult, the negative effect on expensive bond markets that those rises will have may be easier to foresee. We would count this as a strong argument for favouring equities over bond and our preferred strategy remains to hold a diversified portfolio of blue chip companies that are well placed to benefit from world growth, which despite not being at pre-crisis levels, is not unsatisfactory.