meridian

ASSET MANAGEMENT (C.I.) LIMITED

Overall, there was little change in international equity markets in the latest quarter but earlier gains in the quarter were erased by weakness in May as trade war fears increased. Concerns about the threats of a trade war posed to international growth pushed down bond yields as forecasts about interest rate movements changed. In the foreign exchange markets, concerns about the U.K. political situation weakened sterling. In the commodity markets, despite supply concerns, the oil price weakened slightly.

The tables below detail relevant movements in markets :

International Equities 28.02.19 - 31.05.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.2	+8.1	+2.5	+5.1
Finland	-4.6	-1.5	-6.7	-4.6
France	+1.6	+4.9	-0.6	+1.6
Germany	+1.3	+4.6	-0.4	+1.3
Hong Kong, China	-4.5	+0.9	-4.4	-2.3
Italy	-2.0	+1.2	-4.1	-2.0
Japan	-4.7	+3.1	-2.3	-0.2
Netherlands	+1.3	+4.6	-0.9	+1.3
Spain	-0.8	+2.4	-2.9	-0.8
Switzerland	+5.4	+10.2	+4.4	+6.7
UK	+2.4	+2.4	-3.0	-0.8
USA	-0.7	+4.8	-0.7	+1.4
All World Europe ex UK	+1.7	+5.2	-0.3	+1.9
All World Asia Pacific ex Japan	-2.1	+1.9	-3.5	-1.4
All World Asia Pacific	-3.1	+2.3	-3.0	-0.9
All World Latin America	+0.5	+2.0	-3.4	-1.3
All World All Emerging Markets	-1.5	+2.8	-2.6	-0.5
All World	-0.6	+4.2	-1.3	+0.9

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +4.4%

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

Currency	28.02.19	31.05.19
Sterling	1.25	0.87
US Dollar	2.70	2.22
Yen	-0.02	-0.10
Germany (Euro)	0.05	-0.27

Sterling's performance during the quarter ending 31.05.19 (%)

Currency	Quarter Ending 31.05.19
US Dollar	-4.8
Canadian Dollar	-2.2
Yen	-7.2
Euro	-2.9
Swiss Franc	-4.4
Australian Dollar	-2.5

Other currency movements during the quarter ending 31.05.19 (%)

Currency	Quarter Ending 31.05.19
US Dollar / Canadian Dollar	+2.8
US Dollar / Yen	-2.5
US Dollar / Euro	+2.0
Swiss Franc / Euro	+1.5
Euro / Yen	-4.4

Significant Commodities (US dollar terms) 28.02.19 - 31.05.19 (%)

Currency	Quarter Ending 31.05.19
Oil	-4.6
Gold	-3.2

MARKETS

Overall, there has been little change in equity markets over the quarter but this result masks weakness right at the end of the period. In total return terms, the FTSE All World Index returned -0.6%, in sterling terms +4.2%, in US dollar terms -1.3% and, in euro terms, +0.9%. Looking at local currency returns first, there was relative strength from the FTSE Australia Index (+5.2%), the FTSE UK Index (+2.4%) and the FTSE Europe ex UK Index (+1.7%). Within the latter, the strong performance of the FTSE Switzerland Index should be noted (+5.4%). There was relative weakness from the FTSE Japan Index (-4.7%) and the FTSE All World Asia Pacific ex Japan Index (-2.1%). Turning to the sterling adjusted indices, we see a different position. The FTSE Australia Index (+8.1%), the FTSE All World Europe ex UK Index (+5.2%) and, within that, the FTSE Switzerland Index (+10.2%) continued to perform relatively well. Strength in the yen meant that the FTSE Japan Index returned +3.1%, only a little below the sterling adjusted performance of the FTSE All World Index (+4.2%). Importantly, the FTSE USA Index returned +4.8%, thereby outperforming the FTSE All World Index.

International bond markets performed strongly. As measured by 10 year government bond benchmark yields, the gross redemption yield on the UK gilt fell by 38 basis points to 0.87%, on the US Treasury bond by 48 basis points to 2.22%, on the Japanese Government Bond by 8 basis points to -0.10% and on the German Bund by 32 basis points to -0.27%.

In the foreign exchange markets, sterling was weak. Against the yen, it fell by 7.2%, against the US dollar by 4.8%, against the Swiss Franc by 4.4%, against the euro by 2.9%, against the Australian dollar by 2.5% and against the Canadian dollar by 2.2%.

In the commodity markets, oil, as measured by Brent crude, fell by 4.6% and gold fell by 3.2%.

ECONOMICS

It has been a disturbed period politically and economically and weakness towards the end of the quarter has pulled back returns. The fall back in bond yields reflects the unsettled background. So many are on negative yields and others on extremely low ones which suggests that many investors foresee really serious economic developments including a recession. This is not our central case.

The most serious political and economic issue is the growing trade tensions, notably between the USA and China but also bringing in the EU and Mexico. In the fourth quarter of 2018, these trade tensions, along with the prospect of rising US interest rates, exerted a negative influence on international equity markets. In the first quarter of 2019, the Federal Reserve did an abrupt U-turn on interest rates and investors felt that the signs were turning more positive on the trade talks between the USA and China, leading to a strong first quarter performance for international equity markets. Whilst the interest rate outlook remains positive for equity markets, the trade talks have taken a turn for the worse. But before discussing the latter, it is important to qualify the statement about interest rates in a longer term context. Interest rates remain at emergency levels more than ten years after the financial crisis. The attraction for investors has been that quantitative easing and negative or very low interest rates have boosted asset prices, as they were meant to do. If one looks at the relationship between dividend yields and, say, ten year government bonds in most markets, shares look attractive, either because they yield more, and so appeal to income conscious investors, or because, in the case of the USA where the ten year US Treasury bond yields more than the dividend yield on the S & P 500, the relative relationship is favourable. Unfortunately, what was supposed to be a temporary measure is taking on an air of permanency and it seems that low growth areas such as the eurozone can only show even minor rises in GDP because of the extreme monetary policy being followed. This situation is undesirable for many reasons. It distorts the relationship between saver and borrower. For savers, the temptation is to try to achieve greater returns but, in doing so, take risks, some of which end badly. An example in the UK would be the temptation to invest in bonds or similar assets producing very high returns relative to what could be earned on an investment grade bond, for example. Investors have lost money in some cases. On the other side of the relationship, the ability to borrow at extraordinarily low rates of interest encourages overleveraging which seems manageable when interest rates are as low as they are now but which will prove unsustainable if interest rates revert to anything like what they used to be. In the corporate world, this distortion has an undesirable effect on potential growth rates for an economy. It enables "zombie" companies to keep going because low rates of interest allow them to service their debt even if they cannot repay the principal. However, in doing so, they crowd out faster growing more dynamic companies by preventing them from gaining more business and expanding. Were interest rates to stand at more normal levels, the "zombie" companies would not survive thereby opening up greater market opportunities and expansion prospects for other companies. So, by preserving, for the time being, companies which are financially constrained, it penalises companies with more of a future and reduces economic activity and employment levels below what they would be in a more normal interest rate situation. So, at its very simplest, we can say that the distortions caused by ultra low or negative interest rates can encourage undesirable risk taking by savers and investors. As well as taking qualitative risks by buying investments which promise unachievable returns, the risk can also be in pushing up asset prices, whether they be securities, property or other fashionable non mainstream investments, into bubble territory with the danger of an asset price collapse. We can also take the argument to the government level. If we look at the eurozone, there are a number of highly indebted countries which can service their debt at current interest rates but, if interest rates rise to more normal levels, debt levels would become a serious problem. Italy comes to mind as a heavily indebted country with outstanding public debt as a percentage of GDP of over 130%.

These concerns are highly valid but they are for the future. At present, and since the Federal Reserve changed its stance in January, interest rates have, for most of the year so far, been exerting a positive influence on markets but the perception earlier this year that the US/China trade talks were moving in the right direction has been interrupted in recent weeks, hence the recent downturn in markets from a number of all time highs, although there has been a significant recovery so far in June.

A rational person would say that it is in the interests of the USA and China to come to an agreement on trade and other issues. After all, no mainstream economist thinks that protectionism and tariffs are a good idea. They slow down the world economy as trade is inhibited, they introduce inefficiencies and raise costs for consumers and businesses. In economics, simply put, the theory of comparative advantage says that goods should be produced where this can be done most efficiently and, through international trade, consumers' welfare is increased. Distortions introduced by tariffs and quotas raise costs to consumers and businesses and leave less disposable income which affects economic activity. In an ideal world, countries should play to their strengths in what they manufacture and the services they provide and import those goods and services where they do not have a comparative advantage. However, this theory runs into all sorts of practical difficulties as the present dispute between the USA and China shows. To have a level playing field, for example, there must be no subsidies because these cause distortions. The theory only works if there is no distortion. The USA complains that China subsidises industry and the US President is particularly incensed by the "Made in China 2025" strategic plan which aims to make China a high end rather than a low end producer of manufactured goods with particular emphasis on leadership in robotics, information technology and clean energy. To do this, the Americas believe that direct and indirect state help will be required, effectively a subsidy. One of the major complaints by the USA and other countries is that China insists on forced technology transfers as a price of doing business in China. This undermines the theory and the USA sees this practice as a way of obtaining technological leadership at the expense of the USA. This is one of the major sticking points in the negotiations. In passing, and on the subject of trade distortions, one of the biggest battles is between the USA and the EU over subsidies for Boeing and Airbus which has led to threats of tariffs on EU imports by President Trump. One other important issue for President Trump is the size of the trade imbalance between the USA and China. In 2018, the USA imported US$539.503 billion worth of goods etc from China whilst its exports were US$120.341 billion, a deficit of US$419 billion. This deficit rankles with President Trump, but there are two sides to the argument. From an economic point of view, it is not necessarily bad for a country to have a trade deficit. Theoretically, the trade surpluses and deficits of all the countries in the world should balance but that does not, of course, mean that each country's trade account should be in balance. Within a country's trade account in goods and services there will be some countries with which it runs a surplus, where it has a comparative advantage, and others where it runs a deficit because it does not have a comparative advantage. As long as there is a level playing field, i.e. no subsidies, state assistance or foreign exchange manipulation to reduce the value of a currency and give an artificial stimulus to exports, etc., running a trade deficit with a trading partner should not be an issue. The President may feel that China bashing will play well with the US electorate or, at least, those whose support he aims to tap for next year's Presidential election, which is now only seventeen months away. But an investor has to make a judgement on these matters. Bill Clinton's 1992 presidential campaign strategist, James Carville, said something like "it's the economy stupid" and President Trump will want the support of a strong US economy to back up his re-election campaign. So, in making a judgement about how this stand off will end and, hence, influence one's investment thinking, one must work out how these tariffs, if maintained and extended further, will affect the US economy and employment levels and consumers' disposable incomes. If there is a full scale trade war, it is unlikely to be helpful to the President's re-election chances since one would expect to see slower economic growth, rising unemployment and damage to consumers' disposable incomes. This is ultimately about the struggle for world economic leadership between the USA and China but, in the short term, one has still to believe that the President will see it in his re-election interest to come to an agreement with China. At the very least, we do not see sufficient reason to change our generally positive stance towards US equities, especially for sterling based investors.

But we also have to look at the Chinese side. It has been quite clear for some time that President Xi is accumulating more and more power, but there are risks if the economy fails to perform. "Made in China 2025" is meant to accelerate China's move towards economic leadership. A lot is now resting on President Xi to achieve the targets set out in his plan, which makes it very important for him to have the support of a strong economy to ward off any dissent. In his dealings with the USA he cannot be seen to back down, so, realistically, it must be in China's interest to reach a settlement with the USA which does not appear to suggest that China is backing down. The dispute with the USA has already had some economic side effects. The Chinese government and central bank have been concerned about the rise in borrowing levels and had attempted to clamp down on the shadow banking sector. However, the need to stimulate the Chinese economy in order to limit the damage to it from the trade war has meant a loosening of monetary policy, with bank reserve requirements reduced to allow more money to flow to business. A fiscal stimulus has also been given to boost the economy. It is worth noting the pressure being put on the Chinese economy from US tariffs. In 2018, the USA put tariffs of 25% on US$50 billion of Chinese imports and 10% on another US$200 billion, whilst China retaliated with tariffs of between 5% and 25% on US$113 billion of imports from the USA. Now the USA has raised the tariffs on the US$250 billion of Chinese imports which suffered a 10% tariff to 25% and started the process of putting tariffs on a further US$325 billion of Chinese imports. President Trump reckons that, because of the size of the trade imbalances, the USA is bound to win. China has other methods of retaliating and has said that it will establish a list of so called "unreliable" entities which, it says, damage the interests of domestic companies. The Ministry of Commerce has said that China will set up a mechanism listing foreign enterprises, organisations and individuals which do not obey market rules, violate contracts and block or cut off supply for non commercial reasons or severely damage the legitimate interests of Chinese companies. This can be seen as a retaliation for the US government's move to curb Huawei's ability to sell equipment in the USA and buy parts from US suppliers, crucial to one of China's most successful companies. Another pressure on China is more indirect, as foreign companies move production from China or source more from other Asian suppliers. None of this is good news but it is a reason for China to want a deal as well as the USA.

What this does mean, however, is that the outlook for world economic growth is less good than it was and, as a result, investors can be confident that in most major economies interest rate increases are off the agenda. That provides some support for share prices, especially as bond yields are falling to even more astonishing levels. Growth forecasts are mostly being reduced but not to low enough levels to cause major concern. The latest OECD forecast, issued in May, sees world growth this year at 3.2% against 3.5% last year and its forecast for next year is 3.4%. It sees US growth at 2.8% this year, only fractionally below last year's level, and 2.3% in 2020. The main concerns are in a number of the eurozone countries. In Germany, growth is forecast to be just 0.7% this year, well down on last year's level of 1.45%. For 2020, it forecasts German growth of 1.2%. For France, the picture is a little brighter. The OECD sees growth at 1.3% this year against 1.6% last year and it forecasts growth of 1.25% in 2020. The main concern amongst the large eurozone economies is Italy where it sees effectively no growth this year against 0.7% last year and 0.5% for 2020. In the context of our earlier brief discussion about Italy's debt problem, such low growth forecasts have to be a concern because there would be insufficient growth to prevent the country's debt burden from rising. The brightest spot amongst the larger eurozone economies is Spain where growth of 2.2% is forecast for this year against 2.6% last year and the forecast for 2020 is 1.9%. The Japanese economy is forecast to grow by 0.7% this year and 0.6% next year against 0.8% in 2018. The forecast for the UK is 1.2% growth this year against 1.4% last year and 1% growth is forecast for 2020. Elsewhere, and important in the context of what we have been discussing earlier, the Chinese economy is expected to slow down to 6.2% growth this year against 6.6% last year and 6% next year. India's growth is expected to accelerate this year to 7.2% from 7.0% last year and the forecast for 2020 is 7.4%. Recent growth figures in India have, however, been disappointing.

During this recent stress in international equity markets, bond yields in most countries have fallen sharply and many were already at very low or negative levels. For many investment managers and economists, the shape of the yield curve is important. The normal position would be that the longer maturity bonds have higher yields to compensate for the risk of investing longer, including the possibility that short term interest rates will rise, that inflation will rise and perhaps increased credit risk. The shape of the yield curve in most countries is gently upwards but yields are compressed. So, for example, in the important US Treasury bond market, the difference in gross redemption yield between 2 year and 30 year bonds is just 61 basis points. In the case of the UK, it is 88 basis points, in the case of Germany it is 111 basis points and in the case of Japan it is 63 basis points. In the case of Germany and Japan the 2 year base yield is negative. As we mentioned earlier, Italian government bond yields are beginning to show some signs of stress and the difference between 2 year and 30 year bond yields in this case is 284 basis points. The extremely low absolute or negative level of yields at present has much to do with quantitative easing which has taken place and the very easy monetary policy which has been followed but it may also represent a flight to safety by more nervous investors. For many, a downwards sloping yield curve portends a recession. If one looks at the relationship between 3 month US Treasury bonds and 10 year US Treasury bonds, one of the yardsticks which some economists use do actually see a downwards slope, just over 13 basis points at the time of writing. If the yield curve is downwards sloping, it implies that interest rates will be reduced as investors try to lock in longer dated yields. If they believe that a recession is looming then short term interest rates are likely to be reduced so locking in higher longer term rates makes sense. However, except perhaps in the USA and, to a limited extent, the UK, there is not much room to cut interest rates so an investor is not locking in so much of an advantage. That is the theory but the widespread implementation of very loose monetary policy might make the yield curve theory less robust as an economic prediction. If we take the UK where the 10 year gilt has a gross redemption yield of 0.885%, one has to be very pessimistic about economic prospects or to expect significant deflation (very unlikely) to believe that this can be a good investment.

The possibility of a full scale trade war and the collateral damage which this would cause to the world economy is clearly the top consideration for investors at the moment, but what else should they be concerned about given that the other great worry in the last quarter of 2018, the prospect of rising interest rates, has receded and there is the possibility that they may even move lower at the very short end if central banks ease monetary policy? One potential concern, which has always been in the background, is Italy, the third largest eurozone economy and a heavily indebted one with outstanding public debt at over 130% of GDP and rising. Last year, a temporary truce between Italy and the EU was agreed as the populist coalition threatened a budget which would breach the previously agreed guidelines. The agreement with the EU was clearly a fudge since it was predicated on an unrealistic growth forecast. So it has proved, and the Italian Prime Minister plans to introduce major tax cuts which will increase the deficit. The European Commission has now recommended starting disciplinary procedures against Italy which could, theoretically, lead to a large fine for Italy. Fortified by his party's strong showing in the euro elections, the Prime Minister may be in no mood to compromise. He wants to give Italy a "fiscal shock" by means of a flat tax which would eliminate different tax bands and replace them with a single lower rate. If the stand off develops into a positon where Italy could receive a fine from the EC for breaching its deficit and borrowing rules, this would have significant implications for the eurozone and for the single currency. One measure of stress is the yield differential between 10 year German and Italian bonds, which currently stands at just over 270 basis points. It is accepted that if it were to reach 300 basis points, markets would be worried. Italy has drawn up plans for a parallel currency, a mini-BOT, which would be used to settle public sector payments and taxes. This is a nuclear option and, if it were to come into existence, it would threaten the single currency regime. So, Italy is always a potential concern for markets and, at the moment, it is moving towards the front of issues to worry about.

Nearer home, but this is mainly an issue for sterling based investors, is the political problems arising from the Brexit fallout which were evidenced in the euro elections and the Peterborough by-election. It is impossible to know what is going to happen but the biggest risk is not so much Brexit which may or may not have a positive long term benefit for the UK, but the possibility that the crisis may lead to the advent of a hard left government. From news which is coming out, one can see that its policies would be likely to have a significantly adverse effect on the UK stock market and currency because they would be far removed from policies followed previously. Brexit is not a major international issue but it is a very important domestic issue in the UK and, once again, we emphasise to our clients that, where mandates permit, a very substantial part of a portfolio should be invested unhedged overseas. We think that the danger to returns of "home bias" where an investor overweights the home country, perhaps because the securities are better known, is more apparent than ever now. With the UK a high risk market, in our view, we continue to place great emphasis on risk reduction which means holding a substantial proportion of a portfolio in overseas assets.

Although international political and economic concerns have increased over the past quarter, we continue to favour high quality equities as our preferred asset class and it is noticeable that, in the market, weakness in May defensive stocks like consumer staples held up well. Although the trade row has increased the risk of a recession, we think the odds still remain against this occurring and, if the OECD forecasts are anywhere near correct, there should be enough growth to sustain equities. Whilst we can understand why bond yields have fallen to the extraordinarily low or negative levels shown in the table at the beginning of this review, as long term investors based on any plausible economic outlook, we cannot see anything but poor value in them and, if there is any reversion to more normal yields, capital values are at risk. Around US$11 trillion of bonds are experiencing negative yields at the moment. To pay for the privilege of being able to lend to countries with high credit ratings seems surreal.