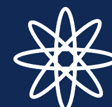

meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Because of the current circumstances, we are producing an abbreviated version of our regular economic review. We hope you will understand why it is necessary to do this with all members of staff working from home and the office unavailable for use until the emergency is over.

Selected International Equities Indices 29.02.20 - 29.05.20

Total Return Performances (£ terms)	%
UK	-7.4
USA	+7.3
All World Europe ex UK	+0.2
Japan	+8.1
Australia	-5.2
All World Asia Pacific ex Japan	-2.5
All World All Emerging Markets	-4.6
All World	+3.4

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +4.1%

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

Currency	29.02.20	29.05.20
Sterling	0.23	0.18
US Dollar	0.61	0.66
Yen	-0.04	-0.07
Germany (Euro)	-0.59	0.45

Sterling's performance during the quarter ending 29.05.20 (%)

Currency	Quarter Ending 29.05.20
US Dollar	-3.5
Canadian Dollar	-0.8
Yen	-3.8
Euro	-4.3
Swiss Franc	-4.1
Australian Dollar	-5.7

Other currency movements during the quarter ending 29.05.20 (%)

Currency	Quarter Ending 29.05.20
US Dollar / Canadian Dollar	+2.8
US Dollar / Yen	-0.3
US Dollar / Euro	-0.9
Swiss Franc / Euro	-0.2
Euro / Yen	+0.6

Significant Commodities (US dollar terms) 31.01.20 - 30.04.20 (%)

Currency	Quarter Ending 30.04.20
Oil	-28.7
Gold	+4.0

ECONOMICS

Whilst the performance of international equity markets over the last quarter, as shown in the indices at the beginning of this review, shows large differences between the various markets, the overall movement as shown by the FTSE All World Index is modest and consistent with a fairly normal quarter. Some may ask how this is possible when the world is suffering from the most dramatic and unpleasant event in modern times, not only from a health aspect but also from an economic one. Surely, we should have seen a dramatic fall in share prices?

Well, we certainly did from the high point of the FTSE All World Index. In sterling adjusted terms from 20th February, the market fell by 25.3% to 16th March and, from that low point, it rallied 24.2% to the end of May and, at the time of writing, has risen further, hence the unremarkable overall result. The important point is that markets look ahead to try to build into share prices their view of various influences which may affect markets. These will mostly be economic and political ones. However, the Covid-19 pandemic was a "black swan" event. Whilst there is always the possibility of a pandemic, it is not a factor which one can reasonably build into one's investment policy because they are so rare. With the pandemic so suddenly and unexpectedly occurring, investors did not have time to discount it and build it into their strategy, hence the dramatic fall in share prices towards the end of February and through part of March. It is important to make a further point here. Those who sold out during this period were probably not long term investors. They may have been investors who were in for the short term, overleveraged investors who had to sell and some investors who thought that they may be happy to hold shares but, in the event, were not. For a variety of reasons, some open ended funds faced large redemptions, forcing managers to sell shares. In these circumstances, the media does not help, very often accentuating the negative. So, with overwhelmingly negative news on the pandemic and its effect on the world economy, markets were hit by a perfect storm.

At times like this, however, as we tried to point out in our special memorandum in early March and our end of March review, it is important for investors to look ahead. It is only natural that many investors look at the situation as it was in late February and March and feel thoroughly intimidated by it. However, the important factors for investors to consider then were in the future as markets are interested in trends. There were two which we highlighted. On the health front, at some stage the news would be less bad (it did not have to be good, just a more encouraging trend) and, in economic terms, that governments and central banks would react to try to stabilise their economies through fiscal and monetary actions and this is what, we think, has driven the recovery in markets. The numbers for the economic stimuli are mind blowing, bigger than after the Global Financial Crisis (GFC) in 2008/9, but the point for investors to take on board is that, on the monetary front, vast amounts of money have been created by central banks to enable them to buy assets in the secondary market, thus giving comfort to those who buy government debt in the primary market that they will be able to sell it. The aim is also to influence and keep low interest rates to encourage borrowing from banks to stimulate economic activity. At its very simplest, there is a lot more money chasing a finite amount of assets, in this case shares. Ever since the Global Financial Crisis, monetary policy has been extremely easy, with only sporadic attempts to tighten it, and this has heavily influenced the performance of share prices since then. Central banks and governments throughout the world have metaphorically thrown the kitchen sink at their economies to preserve their economic structures.

Those who are negative about the international equity markets are highly influenced by the present state of the world economy and its effects on companies. They point to elevated share ratings and their extreme relationship with the past. But, as a firm which considers at the present, in the absence of any mandate constraints, equities to be the preferred long term asset class, we take a different view. Gold and property, we will exclude. At times, gold has been an excellent investment. One of its

attractions is as a store of value in uncertain times. So from late 2008 to late 2011 during the GFC and in the immediate aftermath, gold outperformed shares by a substantial amount and it has also done so far this year, although the performance gap is narrowing after the recent recovery in share prices. At other times, it has significantly underperformed the stock market. The underperformance over the last ten years has been considerable. Gold has never formed anything other than a very minor part of our portfolios and then only indirectly through gold shares. It is never likely to become a mainstream part of our clients' portfolios. We do not invest in physical property for our clients as we are not property specialists, although we have very modest exposure on occasions through REITS. However, from an economic perspective, looking at the implications of the pandemic on business, it is possible to draw some realistic conclusions about property. Firstly, the decline of bricks and mortar retailers is likely to accelerate. The rise of online shopping has been accelerated by the pandemic and it is unlikely that the trend will change. Retail property investment will remain problematic and there have been a lot of missed rental payments during the pandemic. This trend was very apparent before the pandemic moved a lot more business on line. Secondly, the necessity for remote working during the pandemic will surely make many firms consider whether this becomes a mode of operation for part of their business. Many businesses will be in cost saving mode when they emerge from the lockdown and saving on rents could inform their decision to downsize their physical offices. This would not be good for commercial property. The hospitality sector has clearly been very badly hit by the lockdown. How much of it will emerge in the immediate aftermath is difficult to tell, but certainly landlords will have taken a hit. The best area, which was once the poor relation of the sector, is industrial property. With more online shopping, more and bigger warehouses are required and it is noticeable how this is reflected in the relative performance of shares involved in this sector compared with retail or commercial property. Property shares are not likely to form a major part of our clients' portfolios.

So, we will, therefore, consider the relative attractions of shares, bonds and cash in the context of our long term investment strategy. Monetary policy is driven by the need to finance the vast fiscal aid given to the world economy and to suppress interest rates to encourage economic activity as businesses and individuals borrow money at extraordinarily low interest rates. Central banks, except in countries like Venezuela and Zimbabwe, are not supposed to finance governments because, if they do, as in the case of these two countries, the money becomes virtually worthless. But there is a fine line between, as is happening now on a vast scale, central banks buying assets in the secondary market, mainly government bonds and buying them in the primary market. In the normal course of events, if governments were borrowing on anything like the scale they are now, investors, if they were prepared to finance the government at all, would be demanding much higher interest rates. With central banks hoovering up government bonds in the secondary market with newly created money, all sense of price signalling and discovery has gone. The government bond yields, at the beginning of this review, showing minuscule or negative yields, reflect this. The long term objective of an investment portfolio should be to increase its value in real terms. This is not going to happen if investors buy fixed interest securities on these levels of yield and to buy bonds with negative yields which, if held to redemption, will mean a certain loss, cannot be a justifiable investment on anything but the very short term. The risk of a capital loss, if interest rates move towards normal levels, is apparent. Interest rates cannot stay at these levels indefinitely, nor can central banks' balance sheets keep on growing in size indefinitely. Furthermore, we believe that, although inflation levels are very benign at the moment, inflation could be a big problem later and, if that is correct, it would be another reason for bond yields to rise, perhaps quite sharply. How could inflation become a problem? This economic crisis has, unusually, been caused by a supply shock. The shutting down of economies has meant a reduction in the supply of some goods. Usually an economy suffers from a demand shock but, in the case of the pandemic, it is a supply shock which has caused the fall in demand. We do not know how quickly supply will be restored when this crisis has ended, but it is possible to imagine a situation that, when pent up demand is released, the limited supply of goods available will cause prices to increase. From a monetary aspect, the build up of bank reserves as a result of central bank policy could mean that, when businesses and individuals become more confident and borrow, the velocity of circulation of money will increase, which, against a limited supply position, could raise inflation levels. It is, in

many ways, surprising that inflation has been so benign, so benign in some countries that central banks and economists have become worried about deflation, but it is the case that the build up of bank reserves had not found its way into the world economy rapidly enough to cause an inflation problem, but that could change. If inflation does resurface, then this, together with the increase in governments' debts, could cause a sharp rise in interest rates with significantly adverse outcomes for fixed interest investors. Whilst we think that qualitative risks are limited where central banks can issue their own currency, the return risks are very significant over the medium and long term.

If one has a negative view of one asset class then it is likely to increase the relative, if not necessarily the absolute, attraction of the other two we are considering, cash and equities. Cash is always very tempting in uncertain times but, apart from modest liquidity levels and any foreseeable need for funds, it can be a trap. Apart from the fact that there is a little, or negative, yield on cash, it is psychologically difficult to commit money to the market when the background is poor and perhaps only when markets have risen considerably and confidence has returned, will such an investor come back in. But, by then, the damage may have been done because it could be impossible to recover the opportunity cost of having missed out on the market recovery. To hold cash as a core investment can, we think, only be justified in exceptional circumstances. So this leaves shares. Even if one is of a pessimistic frame of mind, one might see them as the least bad investment compared with bonds or cash but, if one is more positive, like we are, there is, we think, a good argument to see them as the preferred asset class on our medium and long term investment horizons.

Firstly, although many companies have cancelled or cut their dividends, the yield on shares is still attractive compared with high quality fixed interest securities. Many investors do require income and good quality companies can provide this. Secondly, if we are right about inflation being a risk in the future, having an investment in real assets would seem the sensible way to address the issue. Many companies will be able to raise prices to offset extra costs and earn profits, out of which they can continue to pay dividends. Thirdly, the vast level of money creation should continue to find its way into equities and, although companies may be in money raising mode, the supply of equities may be more restricted and will provide attractions which bonds or cash cannot.

In practical terms, we must be realistic because there are many obvious risks around and the economic background is dire, with substantial increases in unemployment as GDP contracts and a deep recession occurring. There is also the risk of a second wave of Covid-19 later this year, with very severe knock on consequences for the world economy if countries have to lock down again. We have seen this enormous explosion in government debt as governments have grappled with the effect of the lockdown in their economies. It is fortunate that interest rates are where they are now, which limits the servicing costs of the additional debt, but, at some stage, this will have to be refinanced, we assume at a higher interest rate which will impact on domestic budgets. Normally, if a government's debt or budget deficits are too high, restrictive measures on tax or government spending are introduced to deal with the situation, but that is hardly appropriate now. There are political tensions at a serious level between China and many other countries over trade policies and Hong Kong, and we must not forget the sabre rattling against Taiwan. Then there are risks in the USA and the forthcoming Presidential Election in November which investors have to consider. A world economy which was expected to grow by a modest 3%+ this year will now contract. Wherever one looks, there seem to be problems but, as we have indicated, these do not have to be consistent with a weak stock market.

All the major economies have increased their economic stimuli packages, fiscal and monetary. The figures are so large that they seem almost meaningless out of context. However, one such context is provided by the OECD which has said that rich countries are set to take on at least US$17 trillion of extra public debt. Across the OECD club of rich countries, it is estimated that average government financial liabilities are expected to rise from 109% of GDP to 137%. In normal circumstances, the concern about rising government debt is that it will "crowd out" the private sector as extra debt servicing charges weigh on government budgets and lead to a tighter fiscal policy which makes private sector growth more difficult. Perhaps the main specific area of interest is the eurozone where

two events have particularly raised attention. In Germany, with its legendary economic discipline, the spending taps have been dramatically turned on. The German government coalition has agreed a €130 billion stimulus package, one item of which is a 3% temporary reduction in VAT to try to encourage spending. Money has also been allocated to build out 5G data networks, improve railways and double the incentives for electric vehicles. There will also be a transfer to each family of €300 per child. The measures will raise outstanding public debt as a percentage of GDP from 60% to 80%, but the Finance Minister said that they will work to return that to 60%. At an EU level, and highly controversial amongst some of its members, the EU announced a €750 billion coronavirus recovery fund. Under the plan, the EU will borrow €750 billion by issuing long term government bonds. Out of that money, €500 billion in grants will be distributed to every member state and €250 billion will be available for loans. However, this is hugely controversial because debt mutualisation has been off limits to a number of members including, up to now, Germany. At the moment, the main group of members which is sceptical of the plan is what is called the "frugal four", Austria, The Netherlands, Sweden and Denmark. The plan requires the approval of all 27 EU member countries and the European Parliament, so it is not a done deal. It is, however, highly symbolic that, at a time when almost every country is increasing its own economic stimulus, Germany appears to have moved from an entrenched position. However, there is a problem emanating from Germany, which is its Constitutional Court's ruling on ECB bond purchases and the three month deadline which the Court gave to the ECB to justify the proportionality of its action. This has set up a very serious clash between the ECB and the Constitutional Court and its relationship with the European Court of Justice.

In conclusion, we have tried to rationalise what has happened in markets over the last quarter which has, overall, left markets little changed despite huge intra quarter movements. We have explained why we think that equities should be the preferred asset class despite scepticism about their recent recovery. We have discussed the major problems which the legacy of Covid-19 will leave for economies in terms of increased debt and we have indicated the risks to the world economy of further damage caused by a second wave of the virus. Day to day movements are impossible to forecast with so many uncertainties around and we may see the resumption of the unpleasant volatility if there is a turn for the worse in the news. However, we are long term investors and we have laid out the reasons in this review why equities remain our preferred asset class despite the very unsettling public health and economic background.

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