meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

A sharp change in sentiment in mid October rescued international equity markets from the prospect of quite a poor quarter. In the end, except for U.S. dollar based investors, where the strength of the U.S. dollar took its toll, the result has been satisfactory. For investors in high quality bonds, it has also been a good quarter, notwithstanding our belief that bonds are significantly overvalued. In the currency markets, the feature has been the strength of the U.S. dollar and weakness of the yen as the Bank of Japan increases its quantitative easing. In commodity markets, the collapse in the oil price has been a major feature, acting as a tax cut for many consumers and businesses, but not such good news for many of the oil producers.

The tables below detail relevant movements in markets :

International Equities 29.08.14 - 28.11.14

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-4.2	-7.3	-12.6	-7.7
Finland	+5.6	+6.0	-0.1	+5.6
France	+1.0	+1.4	-4.4	+1.0
Germany	+5.7	+6.1	N/C	+5.7
Hong Kong, China	-0.9	+5.1	-0.9	+4.7
Italy	-1.2	-0.9	-6.5	-1.2
Japan	+12.2	+4.2	-1.8	+3.8
Netherlands	+6.5	+6.9	+0.8	+6.5
Spain	+1.1	+1.5	-4.3	+1.1
Switzerland	+5.1	+6.0	-0.1	+5.6
UK	-0.8	-0.8	-6.5	-1.2
USA	+3.4	+9.7	+3.4	+9.3
Europe ex UK	+3.2	+3.6	-2.3	+3.2
Asia Pacific ex Japan	-2.0	-2.8	-8.3	-3.2
Asia Pacific	+4.0	+0.5	-5.2	+0.2
Latin America	-8.3	-12.8	-17.8	-13.1
All World All Emerging	-1.8	+0.1	-5.8	+0.5
The World	+2.9	+5.2	-0.8	+4.8

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +3.8%

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

Currency	29.08.14	28.11.14
Sterling	2.37	1.93
US Dollar	2.34	2.20
Yen	0.50	0.42
Germany (Euro)	0.89	0.71

Sterling's performance during the quarter ending 28.11.14 (%)

Currency	Quarter Ending 28.11.14
US Dollar	-5.8
Canadian Dollar	-0.8
Yen	+7.5
Euro	-0.4
Swiss Franc	-0.8
Australian dollar	+3.4

Other currency movements during the quarter ending 28.11.14 (%)

Currency	Quarter Ending 28.11.14
US Dollar/Canadian Dollar	+5.3
US Dollar/Yen	+4.1
US Dollar/Euro	-3.0
Swiss Franc/Euro	+0.4
Euro/Yen	+7.9

Significant Commodities (US dollar terms) 29.08.14 - 28.11.14 (%)

Currency	Quarter Ending 28.11.14
Oil	-32.1
Gold	-8.3

MARKETS

International equity markets have nudged higher for most investors although those with a US dollar base have experienced a slightly negative quarter because of the currency's relative strength. In local currency terms, the FTSE World Index has shown a total return of 2.9%, in sterling terms 5.2%, in US dollar terms -0.8% and in euro terms 4.8%. The quarter has seen extreme volatility and, in the early part of October, it looked as if the quarter was poised for a significant negative return. After mid October, there was a strong move upwards.

If we look at returns in local currency terms, the outstanding performer was Japan where a further significant bout of monetary easing was revealed. The local currency return on the FTSE Japanese Index was 12.2%. Elsewhere, there was a slightly above average return from the FTSE USA Index (+3.4%) and the FTSE Europe ex UK Index (+3.2%), whereas the FTSE Latin America Index significantly underperformed (-8.3%) as did the FTSE Australia Index (-4.2%). The FTSE All World All Emerging Markets index returned -1.8%, the FTSE Asia Pacific ex Japan Index returned -2.0% and the FTSE UK Index returned -0.8%, all underperforming the FTSE World Index. However, in sterling currency adjusted figures, there are some big changes. The best performer was the FTSE USA Index which returned 9.7% as the US dollar performed strongly against sterling. The weakness of the yen pulled down the return on the FTSE Japan Index to 4.2%. Weakness in the Australian dollar increased the negative return on the FTSE Australian Index to -7.3%.

The extraordinary movements in the bond markets have continued. Taking the ten year government benchmark bonds, the gross redemption yield on the UK government bond fell by 40 basis points to 1.93%, that on the US Treasury bond by 14 basis points to 2.20%, on the Japanese government bond by 8 basis points to 0.42% and on the German Bund by 18 basis points to 0.71%.

There were some big movements in the currency markets. Against the US dollar, sterling fell by 5.8%, against the Canadian dollar and Swiss Franc by 0.8% and against the euro by 0.4%. On the other hand, sterling rose by 7.5% against the yen and by 3.4% against the Australian dollar.

In a weak commodity market, oil, as measured by Brent crude fell by an astonishing 32.1% whilst gold fell by 8.3%.

ECONOMICS

As we move towards the last month of the year we can start thinking about what sort of year it has been. Using the broad FTSE World Index as a reference point, as that is the benchmark we normally use for our international equity portfolios, in sterling terms it is in positive territory for the month of November, for the recent quarter and also for the first eleven months of the calendar year. This hints at an uneventful and profitable gain through 2014 but it has not always felt like that. We are now six full years past the darkest days of the financial crisis and the failure of Lehman Brothers and such was the scale of the collapse of the financial system that we still use the word 'recovery' on a daily basis. The volatility markets experienced in October was, more than anything, about perceptions of the intentions of the European Central Bank to intervene and a downgrade of the IMF's world growth forecast for this year and next, with leading European countries facing the harshest revisions. As markets have recovered it is interesting to note that the last time we had such a sharp fall in markets, it was the so-called 'taper tantrum' in the spring of 2013, which was also the consequence of central bank comments; then, it was the Federal Reserve hinting that it would, at some point, start to taper its quantitative easing programme in the future. Six years ago it is unlikely that many commentators or economists would have predicted that the words and extraordinary actions of central bankers would remain so significant for such a long period.

The month started with the Bank of Japan announcing that its already expansive quantitative easing programme would be extended from ¥60 trillion to ¥70 trillion to a new figure of up to ¥80 trillion (£430 billion). The markets rose and the Yen weakened, as investors drew comfort that commitment to the cause remains undimmed. Indeed, the pattern of market movement in response to such news is as strong in the positive as it is in the negative.

Japan's ambitious bond buying plan is centred on taking Japanese Government Bonds off the balance sheets of its banks, which, once replaced with cash, will spur on banks to fund lending to business and consumer alike and sponsor a recovery. As well as the benefit that may bring, the policy has the added benefit of cleansing the banks, which have become overly stocked with government debt. Since launching its quantitative easing programme in April 2013, the Japanese banking system's holdings of government debt have shrunk by 9% and, if the expanded programme continues to 2016, it would equate to a reduction of around 58%. The IMF warned in 2012 that Japanese banks would face losses large enough to wipe out 26% of the Tier 1 capital of the country's smaller regional lenders if interest rates rose by 1% in 2017. This would be caused by government fixed interest bonds falling in value significantly as they became less attractive compared with securities and bank deposits earning newer and higher rates. These marked to market falls would have to be reflected in the banks' financial statements.

Whether banks will manage to find enough lending to do, which would contribute to economic growth, the Bank of Japan's intention, is difficult to predict. A weakening Yen may deter Japanese companies from investing overseas and expanded credit may find its way into secondary areas such as asset lending which may only end up raising stock and house prices. The other immediate effect of such loose monetary policy is that the Yen has lost value. Two years ago one dollar was worth around ¥80, now it approaches ¥120.

On 17th November, Japan slipped into recession, using the textbook definition of two successive quarters with negative growth. According to the Cabinet Office growth in the third quarter of the year was -1.6% on an annualised basis, far worse than had been expected. The most significant policy decision in 2014 has been the increase in sales tax from 5% to 8% on 1st April, which came at a time when there was a strong argument against it. The backdrop was, and is, that Japan's level of government indebtedness is so high that the government found itself between a rock and a hard place – raising a tax on consumption with the detrimental effect that would have on the economy or being seen in the debt markets as being unable to manage its debt mountain. The choice was taken to increase the tax and the hope is now that the outcome in the medium term will be more favourable than in the short term.

With inflation falling further below the Bank of Japan's 2% target, the level of aggregate demand in the country is not responding to the copious amounts of medicine that the government is administering. The cost of living, partly due to the tax rise, has risen but wage growth has not kept up with price rises and the Prime Minister, Shinzo Abe, has shelved plans for the second half of the sales tax rise which was due on 1st October 2015 and has called a General Election.

There was a time when a weakened Yen would be a sure fire way of boosting the economy as exporters' prices fell in foreign currency terms. This does not seem to be having the desired effect this time and what with the closing of its nuclear reactors and the need to increase imports of oil and gas, Japan has become a net importer. It should be a beneficiary of the slump in such commodity prices of late.

The new phase of recovery is associated with faltering demand and the Governor of the Bank of Japan acknowledged this with his comment this month that "There was a risk we could face a delay in eradicating the public's deflation mindset." Europe and Japan, which together represent around 15% (World Bank) of the world economy, find themselves in similar positions, in that the spectre of deflation threatens their ability to rise out of their current levels of high indebtedness. The fundamentals of debt for a sovereign state are no different from those which affect the individual. In both cases growing income will, in effect, reduce the burden of indebtedness and shrinking income will increase it. Deflation represents the tipping point at which an economy starts shrinking and, ergo government investment and debt servicing can be adversely affected through its diminished tax receipts. It is of course important to point out that, were this to happen for a short period of time, then the effect will be small but, as Mr Kuroda warns, a change of mindset with consumers and companies deferring spending in the hope of lower future prices and being preoccupied with debt servicing creates favourable conditions for the circumstances to persist.

Capping what has been a turbulent month for Japan, Prime Minister Abe, as mentioned above, dissolved the lower house of the Japanese parliament on 21st November and called a snap general election on 14th December, seeking affirmation of his mandate to continue his current policies. On 1st December credit rating agency Moody's Investors Service cut Japan's credit rating by one level to 'A1', putting it on a similar level as Israel, Oman and the Czech Republic. Moody's cited uncertainty over whether Japan will achieve its deficit reduction goals and succeed in boosting growth in the world's third largest economy.

One place where the actions and words of the Bank of Japan will be of particular note will surely be within the four walls of the European Central Bank as the position in which the euro area and Japan both find themselves draws many comparisons at the current time and the level of international concern is rising in respect of both. In recent weeks the International Monetary Fund, the American government and now, Mario Draghi, the President of the European Central Bank have sought to increase the pressure on European policy makers to act decisively. The fear, increasingly, is that Europe could struggle to escape from a state of economic torpor in much the way Japan has struggled over the last years. Mario Draghi was speaking on 17th November and explicitly raised, for the first time, the possibility of the ECB buying sovereign debt, something which is being strongly resisted by Germany. As significant as that would be, his comments regarding the governments of Europe were equally noteworthy. He said "2015 needs to be the year when all actors in the euro area, governments and European institutions alike, will deploy a consistent strategy to bring our economies back on track… Monetary policy alone will not be able to achieve this." The ability of the governments of Europe to reform their economies, notwithstanding the tools that those individual countries lack due to monetary union and a shared currency, is being tested. Italy and France remain the two countries where the need for supply side reforms is the greatest and are, of course, the second and third largest economies in the bloc. Both experienced growth close to zero in the third quarter, with France slightly above and Italy slightly below. Both suffer from high levels of unemployment and, unhelpfully, both would be countries where it is perceived it is difficult to do business. The respective prime ministers have been strong on rhetoric until now but persuading trade unions and other interest groups of the merits of such reform has, for successive governments, proved a difficult task. French economy minister Emmanuel Macron commented "Europe is in difficulty, but France is in more difficulty" adding "We must increase our growth potential. France needs renovation and to open itself up." Whether M. Hollande is able to deliver these must be open to doubt.

Mr Draghi's pointed comments highlight something that may become increasingly apparent. Inflation globally is failing to respond to the unprecedented level of monetary stimulus that so many countries have foisted upon their economies. For a crisis that was born and grew in the financial sector quantitative easing has done its job in rescuing the banking sector with remarkably few casualties. The casualties that there were reminded the powers that be that putting the fire out was always more important than finding out who started the fire. Banks benefited from inflated asset prices, it removed funding issues and sponsored an accelerated repair of their balance sheets. As the glowing embers gradually die down we find ourselves in a post-crisis world where investment in real assets, as opposed to financial assets, is not rebounding as expected and this despite interest rates being at a record low and for a record period.

A review of what has happened in the eurozone and what has been done is interesting because one could conclude that the ECB has, in many ways, delivered on its mandate. In the early days of the financial crisis, when there was a realistic chance of a systemic banking failure, the ECB provided unlimited liquidity to its banks. In 2010 it responded to country-based liquidity issues with its Securities Market Programme (SMP), buying bonds (mainly sovereign) from banks and other institutions. Later, when it was clear that Greece was unable to meet its liabilities, the bank responded with its Outright Monetary Transactions (OMT) programme where the bank would stand by as a 'purchaser of last resort'. Despite the fact the ECB never used the scheme, OMT is credited with supporting the euro sovereign debt market at a time of great vulnerability. The current assistance the ECB offers is its TLTRO (cheap loans to banks which are linked to onward lending to small and medium sized companies) and its purchase of covered bonds and asset backed securities. These two are still in their infancy.

The question now, which Mr Draghi seems to be asking is 'In the circumstances we find ourselves, what reasonably are the limits of what a central bank can be expected to achieve?' The ECB has protected the banking sector and the failures that there have been have been contained, it has improved the borrowing costs of the individual member states and in some cases averted a buyers' strike and has kept interest rates artificially low with the beneficial effects on debt management that that has had. It is not as if there is a lack of awareness of the true issues as Angela Merkel acknowledged recently when she said "the debt of almost all European countries and the lack of competitiveness compared with the best in many places around the world are two of the key challenges we face." Whilst the central bank can influence debt servicing costs and perhaps the exchange rate, it can be excused for feeling exasperated at times that, whilst the symptoms are being treated, the causes are not being addressed.

On 5th November the European Commission rubber stamped Britain's status as Europe's leading economy when it upgraded the country's growth forecasts whilst slashing its outlook for the eurozone. The E.C. now believes the British economy will grow 3.1% in 2014 and 2.7% in 2015. Previously the figures were 2.7% and 2.5%.

Many forecasting bodies, including the European Commission and the International Monetary Fund, hold the United Kingdom and the United States as economies which are best placed to grow and the rates of growth are pretty similar. The pound has, however, fallen significantly against the dollar over the last five months, from a peak of $1.7165 on 1st July to $1.5623 on 28th November as fears grow that trade with Europe could blunt growth if the economic malaise on the European mainland worsens. The most immediate consequence of this is that the first interest rate rise in the UK could now be pushed back into the second half of 2015 as concerns grow about the level of indebtedness, both personal and public, that could negatively impact the country's capacity to grow.

Returning to the European Commission forecasts, it cut its eurozone projections from 1.2% to 0.8% for 2014 and 1.7% to 1.1% for 2015. The IMF, in October, whilst not changing its healthy projections for Britain, also reduced its projections for mainland Europe, amongst which was a reduction of 0.5 percentage points for Germany in 2014 and 0.2 percentage points for 2015. At the same time the German government said it now expected growth in the country to be 1.2% in 2014 and 1.3% in 2015, down from 1.8% and 2.0%. Whilst the structural issues that France and Italy face have attracted much comment, mostly because of the lack of success their governments have had in implementing much needed supply side reform, it is worth commenting on Germany's situation. It is easy to think of Germany in the image of one of its products – a precision engineered machine that exudes reliability and superior performance, but it is wrong to present the situation as being wholly positive.

Germany has experienced less growth than average among eurozone countries since the millennium, productivity has increased only slightly and two out of three employees earn less than they did in 2000. Germany has prided itself on its disciplined national accounting and by 2016 by law the country will restrict itself to borrowing no more than 0.35% of GDP in any year; EU rules allow for a budget deficit of up to 3% in the short term. This has been achieved through a significant scaling back of public (and private) investment and, according to figures from the Federal Statistics Office, total investment in infrastructure such as roads, bridges, schools and factories has fallen from 25% of total economic output in the early 1990s to 19.7% in 2013. It is estimated that around half of all autobahn bridges are urgently in need of repair. Germany has slipped from third to seventh place in the list prepared annually by the Global Economic Forum in Davos over the last six years. The country has also decided to transform how it generates energy with a pledge to use 60% renewable sources by 2050 under its *Energiewende* [energy transition] policy. This has included the closing of its nuclear reactors and a current reliance on expensive new coal power stations. Energy costs have risen because of this and also because of €23bn. of charges this year that consumers must bear as an allocation charge for renewable energy. An example of the unwanted consequence of this was given when the Head of BASF, Kurt Bock, cited natural gas costing a third of the German price as being a factor when deciding to invest €1bn. on the American Gulf Coast. Crumbling infrastructure and high energy costs are unattractive to companies. From the 1st January Germany will have a minimum wage, for the first time, of €8.80 per hour which will doubtless improve the living standards for many low earners but it is estimated that it could cost 200,000 jobs. Added to this is Germany's rapidly ageing population which will decrease in number from over 80m. now to under 60m. at the turn of the next century. France and U.K. are forecast to do the reverse, and increase from around 60m. now to over 75m. over the same period. For Germany, this translates into a lower figure for 'total hours worked' which is forecast to peak in just a few years.

Mr Draghi, it seems, has a strong idea on what needs to be done but it emerged during the month that there is a range of views on the European Central Bank's governing council. The opposing view to Mr Draghi's would be those members who want to see all conventional monetary stimulus (i.e the current TLTRO scheme which provides cheap loans to banks, subject to lending targets) to be exhausted before considering full blown bond purchases. Germany seems unmoved in its view that the ECB's purchase of bonds could weaken member countries resolve in prudently managing their finances and lead to a rise in borrowing. "You cannot solve a debt problem by borrowing more money". This insight was provided by Jean-Michel Six, the Chief European Economist at credit rating agency Standard & Poor's, who questioned whether the measures currently proposed will be enough to avoid the eurozone lurching deeper into recession and, ultimately, whether the eventual purchase of government bonds by the central bank is legal. Eurosceptic groups and academics in Germany are preparing their case, should bond purchasing reach as far as sovereign debt. They argue this risks large potential liabilities for the German taxpayer and circumvents the budgetary sovereignty of the Bundestag. A similar case is currently with the European Court of Justice whereby Germany has questioned whether OMT constitutes economic assistance rather than monetary assistance and is, therefore, beyond the remit of the central bank. Under the 2012 OMT programme the ECB can buy government bonds from certain countries (with the intent of keeping their cost of borrowing down) as long as the country meets certain economic targets.

Looking now at the United States, markets did not react to news that the Republicans took control of both houses of Congress at the beginning of month but were more enthused to note that, despite uncertainties across the ocean(s), economic growth in the third quarter was a healthy 3.9% on an annualised basis, revised upwards from 3.5% in October and it now means that the last two quarters represent the strongest six month period of growth since 2003. November marks the first month when the Federal Reserve is not increasing its purchase of bonds and quantitative easing is now being applied increasingly unevenly in the world's leading economies.

It is worth considering what the practical effects of monetary policy have been on your average multinational as it is no coincidence that the extraordinary efforts of central banks have been accompanied by strong and consistent rises in the shares of those companies. The simple economic definition of the interest rate is that it is the price of money - the reward you will receive by lending it or the price you will pay if you are the borrower. It follows that, in boom times, interest rates will rise and in times of economic crisis rates will fall as 'price' adjusts so that supply and demand balance out. In the aftermath of the financial crisis developed countries found themselves swamped with debt and were threatened with a buyer's strike. Alongside that, banks were no longer motivated by the profitable business of lending money as their capital reserves dwindled under the weight of bad debt. If you are in a hole the first thing to do is stop digging. Sensing danger, money was abruptly pulled from banks and placed somewhere safe and there was nowhere better than 'AAA' rated sovereign debt. Interest rates were cut to historic lows, banks were flooded with central bank deposits and commercial banks were taken out of intensive care and placed in long term recovery.

Moving back to our hypothetical multinationals, they now found themselves in a position where interest rates had been set to deal with this financial crisis, not a deep recession. These companies found strong demand for their debt and were able to refinance their borrowings, extend the duration and even increase their debt levels, but at a more affordable cost. Alongside this, managing costs has been easier in straitened times, margins have improved and cash has accumulated on their balance sheets to record levels due partly to restrained business investment. The strongest companies' sales figures have moved ahead and many corporates have found, and continue to find, success in translating single digit sales growth into double digit earnings growth. Ultimately it is earnings, current and future, that support share prices.

Another phenomenon of these times is the popularity of share buy backs, which have contributed directly to rises in equity markets. Cash on the balance sheet serves little purpose in the current environment and a number of companies have even increased their borrowings to fund share buybacks arguing that they can borrow at a lower cost than paying the dividends. Also debt interest is tax deductible and interest income is taxable. This has, of course, been to the advantage of the investor and nowhere has this been more prevalent than in the United States. According to The Economist, the companies in the S&P500 index bought $500bn. of their own shares in 2013, close to the high reached in the bubble year of 2007, eating up 33c. of every dollar of cash flow. From 2004 to 2013 Exxon Mobil spent over $200bn. in share buy backs and Cisco Systems spent 69% of its cash flow from operations on share buy backs over the same period.

The effect of such buy backs is clearly positive for shareholders and has contributed to the October reporting season in the United States being broadly positive. The economics of low interest rates has been, and continues to be, helpful for companies. They continue to manage costs, expand margins, refinance or raise debt at lower rates, increase the duration of their debt and buy back shares.

It also explains the perceived nervousness there is about interest rates rising. Again, the actions and words of central bankers are analysed for nuance and context to understand when and by how much rates are likely to rise. There is a slight irony in that, historically, share prices have done well in times of rising interest rates as the implication is that rates rise in times of rising inflation as overall demand in the economy grows. At this particular time it may be that there is a period of discomfort that will accompany the withdrawal of the economic subsidy to companies that low interest rates offer.

Another aspect of the debate on rising interest rates, and we still remain some time off rates rising in G8 countries, is the disruptive effect it could have on capital flows around the globe. Money will seek out a return and with sterling, dollar and euro interest rates and yields having been so low capital has flown into emerging market currencies, equities and bonds and then at times reversed. A possible unwinding of this trend has probably been delayed by more aggressive policy by the European Central Bank and the Bank of Japan this month and has reduced the focus on second guessing the policy trend of the Federal Reserve. This notwithstanding, the gap in valuations between emerging stocks and developed market stocks is at its widest in a decade, but this is probably driven by a lack of conviction about the prospects for emerging market corporate earnings, especially given their performance over the past few years. Meridian's policy of investing in emerging markets is unchanged. Exposure will be through holdings in multinationals with strong exposure to such growth markets, which are well placed to achieve strong risk-adjusted returns, as well as certain closed ended funds and exchange traded funds covering the area.

The exceptional monetary policy actions outlined in this review have been a significant reason for the strength of many asset prices, but the quality of the rises has not been of the best. One would much prefer to see faster and more balanced economic growth since share prices cannot go on rising for ever unless the economic data is much more supportive, providing a better foundation for earnings and dividend growth. At some stage, bond yields will have to move towards more normal levels which implies a big risk to bond prices. We see no better asset class in which to be invested than equities but returns so far this year, quite well above the level we expected, do not reflect positive news overall. We must expect periods of weakness but notwithstanding their sharp rise, shares do not look greatly overvalued and with interest rates likely to remain very low for some time are likely to find monetary policy supportive.