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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

What looked as if it could be a significantly negative quarter for international equity markets was rescued by a strong recovery in October to leave these markets only modestly lower over the period under review. Concerns about China, which surfaced in August, have slightly lessened but, in truth, there was no fundamental reason for the wild gyrations in equity markets. Bonds have enjoyed a modestly successful quarter whilst currency movements have been less pronounced than in previous quarters. Commodities have remained depressed.

The tables below detail relevant movements in markets :

International Equities 31.07.15 - 30.10.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-7.1	-8.8	-9.7	-9.7
Finland	-0.7	+0.4	-0.7	-0.7
France	-3.3	-2.3	-3.3	-3.3
Germany	-4.1	-3.1	-4.1	-4.1
Hong Kong, China	-6.7	-5.7	-6.6	-6.6
Italy	-3.8	-2.8	-3.8	-3.8
Japan	-5.6	-2.0	-3.0	-3.0
Netherlands	-5.3	-4.3	-5.3	-5.3
Spain	-8.3	-7.3	-8.3	-8.3
Switzerland	-4.4	-5.8	-6.8	-6.7
UK	-3.9	-3.9	-4.9	-4.9
USA	-1.0	N/C	-1.0	-1.0
Europe ex UK	-4.5	-4.1	-5.1	-5.0
Asia Pacific ex Japan	-3.8	-4.3	-5.3	-5.3
Asia Pacific	-4.9	-3.1	-4.1	-4.1
Latin America	-5.8	-11.7	-12.6	-12.6
All World All Emerging	-4.0	-6.2	-7.2	-7.2
The World	-2.7	-1.9	-2.9	-2.9

Source FTSE World Indices

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

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

Currency	31.07.15	30.10.15
Sterling	2.01	1.92
US Dollar	2.20	2.15
Yen	0.41	0.30
Germany (Euro)	0.65	0.52

Sterling's performance during the quarter ending 30.10.15 (%)

Currency	Quarter Ending 30.10.15
US Dollar	-1.1
Canadian Dollar	-0.9
Yen	-3.8
Euro	-1.3
Swiss Franc	+1.0
Australian dollar	+1.2

Other currency movements during the quarter ending 30.10.15 (%)

Currency	Quarter Ending 30.10.15
US Dollar/Canadian Dollar	+0.3
US Dollar/Yen	-2.6
US Dollar/Euro	-0.1
Swiss Franc/Euro	-2.3
Euro/Yen	-2.5

Significant Commodities (US dollar terms) 31.07.15 - 30.10.15 (%)

Currency	Quarter Ending 30.10.15
Oil	-5.8
Gold	+4.0

MARKETS

The September recovery in international equity markets has meant that, although returns on markets were negative over the quarter, falls were relatively minor, and, for the year as a whole, there is little change. Looking at markets in local currency terms first, we see countries and areas of relative underperformance in Australia, Latin America, Japan and emerging markets where the relevant FTSE World indices have returned -7.1%, -5.8%, -5.6% and -4.0% respectively. The FTSE World Index in local currency terms returned -2.7%.

The main area of relative outperformance was from the FTSE USA Index which returned -1.0%. In sterling adjusted terms, the negative returns from Australia, Latin America and emerging markets widened to -8.8%, -11.7% and -6.2% respectively. However, strength in the yen meant that the sterling adjusted return on the FTSE Japan index was almost in line with the sterling adjusted FTSE World Index at -2.0% against -1.9%. The UK's underperformance widened slightly with the FTSE UK Index returning -3.9%. With the U.S. dollar strengthening, the FTSE USA Index was flat in sterling adjusted terms to show the best relative performance of the major markets.

International bond markets, as reflected in ten year government bond yields, improved during the quarter. The gross redemption yield on the ten year UK government bond declined by 9 basis points to 1.92%, on the US Treasury bond by 5 basis points to 2.15%, on the Japanese government bond by 11 basis points to 0.30% and on the German Bund by 13 basis points to 0.52%.

In the currency markets, the main feature was the yen against which sterling fell by 3.8%. Against the US dollar, sterling weakened by 1.1%, against the euro by 1.3% and against the Canadian dollar by 0.9%. On the other hand, sterling rose by 1.0% against the Swiss Franc and by 1.2% against the Australian dollar.

In weak commodity markets, oil, as measured by Brent crude, fell by 5.8%, whilst gold staged a minor recovery, rising by 4.0%.

ECONOMICS

The starting point for this month's investment memorandum is the International Monetary Fund's most recent World Economic Outlook, its half yearly high level report that summarises its current thinking on the economic prospects for the world economy. Continuing a pattern that has been established by a wide range of economists around the world and over numerous years, it has revised downwards its global growth forecast for 2015 and 2016. Citing a slowing in emerging markets and a modest pick-up in advanced economies it now estimates growth in the world economy will be 3.1% in 2015, which is 0.3% lower than in 2014 (and 0.2% lower than it was forecasting in July 2015). It expects 2016 will be stronger, rebounding to 3.6%. The IMF Economic Counsellor and Director of the Research Team, Maurice Obstfeld, comments "Despite considerable differences in country specific outlooks, the new forecasts mark down expected near term growth marginally but nearly across the board. Moreover, downside risks to the world economy appear more pronounced than they did just a few months ago."

It is instructive to reflect on what factors are contributing to this negative sentiment and, in broad terms, three areas are worth highlighting. These are, firstly, the economic slowdown in China, secondly, and not wholly unrelated, the fall in commodity values and, thirdly, the probable imminent rise in U.S. interest rates. It's also worthwhile observing that the modest revisions to world growth by the IMF express a sense of caution rather than ringing alarm bells. This level of growth is not unhealthy but it is below the longer term trend level and, as mentioned earlier, there has been a repeating pattern of economists over estimating the propensity for the growth rate to rise to the pre crisis level. Relative to last year, economic growth is forecast to improve slightly in developed countries whilst emerging and developing countries are likely to see lower growth for the fifth year in succession, with the slowdown in China and Brazil, as well as the effect on oil exporting countries, taking its toll.

Over the longer term, China's government deserves credit for the country's emergence as an economic heavyweight. Policy has carefully steered the country away from its agrarian past and the level of social and economic change in such a short period of time is without parallel; the country now has around 51% of its population living in cities, according to its National Bureau of Statistics. It now has over 160 cities with populations over 1 million and 14 cities of over 5 million people. Economic growth has, however, been spread unevenly across the population with large areas of the rural population living lives that have barely changed. Going back 15 years, economic growth was around 8% per annum, rising to a peak of over 14% in 2007. This fell sharply to around 6% in the depths of the financial crisis before rebounding to 12% in 2010. Since then there has been an ongoing decline in the rate, which recently reached 6.9%. It must always be stressed that this is the official government rate and many private sector estimates suggest that the true rate is much lower. One such measure of 'proxy GDP growth' is based on electricity, freight traffic and real loan growth. Whilst real loan growth remains strong the two other real economy measures have fallen and would suggest the true rate of growth is much lower than the government figure. It must also be borne in mind that it has been stimulus measures and borrowing that have provided much of the economic impetus to put the country in a position where it has climbed the wealth ladder, from a fairly low rung. There are powerful reasons why growth will not continue to be fuelled in such a way.

Capital spending creates economic activity as there is, in the first place, the economic benefit of the project taking place which creates employment, demands resources and employs professional services and, provided the scheme is well directed, an ongoing economic benefit of the spend. The extraordinary quantum of government sponsored infrastructure spend over the last decade or two across the country has provided a bridge between the wealth creation derived from China's emergence as an exporting manufacturer to the world and the new and necessary transition to a consumption led economy driven by its own burgeoning middle class. Government, both central and local, state owned firms as well as private sector investment have generated economic growth through investment in the country's new roads, railways, ports and housing stock though the country has, as a consequence, abruptly reached a level of indebtedness that invites a prudent change of strategy. The ratio of credit to GDP, following various post crisis stimulus packages, has risen sharply and this debt is concentrated in the corporate sector, especially in state owned enterprises (SOEs) and local government financing vehicles. Whilst this creates fewer immediate risks than an excess of personal debt, it does make the long overdue reforming of industries such as steel, aluminium and chemicals much more complicated. Overcapacity and overproduction, as the economy slows, also have a knock on effect beyond its shores, something which has affected the UK over the month.

Some signs of the building pressures within China were seen this month when Sinosteel Co. failed to pay interest on a 2 billion yuan (£200m.) bond on 20th October. Sinosteel, a state owned steelmaker, followed two other state owned businesses that earlier this year defaulted on their debt. This throws light on both the commercial pressures such businesses are under in a slowing economy and the commitment of the government to stand behind such firms. Premier Li Keqiang has spoken in the past about weak state firms and referred to them as zombie businesses. In October, reflecting the balancing act that is necessary, he said that the government would prevent systemic risks and banks should not cut or withdraw lending to companies which are in "temporary" difficulties. As has been shown in other countries and other markets, an absence of 'moral hazard' creates a distortion of the market.

Another area where the government's involvement may be creating moral hazard is in its capital markets. China has, and is, working hard to expand the standing of its capital markets and to move them to the point that they can function alongside other means of capital raising. China has introduced numerous changes establishing a clear path towards a liberalised and independent stock market. However, Beijing's recent interventions to halt the substantial slide in its 'A' share market and rescue onshore retail investors raises doubts about its commitment to the free market model. For many international investors' confidence in the freedom of the markets has been eroded by this interventionist approach.

Returning to the subject of economic growth rates, it is fair to say that the Chinese government's ability to shape the economy and to sponsor growth must now be lower than it was in the very recent past and, as the economy matures, it quite naturally seeks to refocus on domestic consumption. For any country with aspirations to manufacture and export, an abundant and cheap labour force is a central requirement. As the cost base rises in China there are now even cheaper countries in which international companies can base their manufacturing. A smaller side to this nascent trend is 'reshoring' or 'onshoring' where industrial production is moved away from China and back to the market where the consumer is based. An example of this would be the Raspberry Pi educational mini-computer that is used as an early tool in teaching computer programming in schools. The bulk of production was switched from China to a Sony factory in Wales. A second factor that Beijing must confront is the ability to create economic growth by investing in infrastructure and housing. This is limited by the capacity to borrow and, to a lesser degree, the diminishing marginal benefit of the money invested. These two facets have changed and continue to change. Thirdly, animal spirits are hard to contain. Once the population becomes mobile, more affluent and more autonomous in its decision making, controlling how its wealth is spent can create the conditions that lead to bubbles and crashes in property, local capital markets and other goods pricing, something which is hard to control. Fourthly, China has become more outward looking. It aspires to elevate its currency to hold the status of a world reserve currency through inclusion in the IMF's Special Drawing Rights and the way it has managed its currency does not sit well with that aspiration. It still places caps on how much money its residents can take out of the country, the process of international companies bringing large sums in is bureaucratic and foreigners face restrictions on investing in its capital markets. With size comes responsibility and the international community has an ever growing expectation that China will not move its currency to achieve its own ends and will play to the rules on, for example, intellectual property, piracy and working conditions, though its relationship with the concept of free market forces is complicated and inconsistent. In terms of reforming policy it would seem that the Chinese leadership cannot be viewed as a singular, uniform entity and certain functions of the governing powers, such as the central bank and the stock exchange would seemingly be more willing to adopt more international convention in their areas.

The magnitude of uncertainty around China extends beyond the ability of its government to keep it moving in the right direction and at the right pace but, as suggested earlier, it has been relatively successful in achieving its goals. The job does, however, keep getting harder. The summer stock market volatility proved what was previously suspected, that volatility in China can translate to volatility in other areas of the world. The transmission process is more traditionally from wealthy developed western markets to emerging markets but with over 50% of world output now accounted for by developing markets on a purchasing power parity basis there is now the increasing likelihood of this working more bilaterally. Looking specifically at China, the world has no experience of a financial crisis in the country, not having witnessed a recession there. Furthermore, the level of indebtedness has risen to such a level in such a period of time that it is difficult to gauge how economically stable the country is at the present time. According to figures from the management consultancy McKinsey, China's level of indebtedness has quadrupled since 2007 rising from $7tn. to $28tn. by mid 2014. At around 280% of GDP China's debt as a share of GDP, whilst still manageable, is higher than that of the United States or Germany, with half of loans linked directly or indirectly to China's real estate market, unregulated shadow banking accounting for nearly half of new lending and the debt of many local governments looking unsustainable. This is not meant to read as a forewarning of impending catastrophe but more so as an explanation of the market reaction to news coming out of the country recently.

Moving on to the second connected point, a broad range of commodity prices has fallen through the year due to a number of factors, with China often mentioned as a causal factor. China buys around an eighth of the world's oil, a quarter of its gold, almost a third of its cotton and up to half of all the major base metals. It is quite clear that any change in the growth trajectory of the country will have a significant effect on prices in those markets. Not only because price is affected by China's level of demand but also because China's growth has encouraged a glut of new supply, from fertilisers to gold to iron ore and the time taken for a supply side project to move from drawing board to output can take many years given the scale of such projects. The upfront cost of developing such projects can be staggering with the return on capital deployed coming over decades of production, at prices that are as yet unknown.

Discounting lower future prices into a current commodity producer's share price is difficult and Glencore and, to a lesser extent, Anglo American are two such businesses whose share prices have come under significant pressure recently but the effects on wider commodity markets have also had a spillover effect into other areas of the market, widening and amplifying the sense of economic slowdown. It would not be correct to say that falling commodity prices are only an emerging markets problem as other exporting countries such as Australia and Canada have seen falls in their currencies and it would not be correct to say that all emerging market countries are affected by such falls as many are net importers, meaning that lower prices provides an economic boost - China and India would be examples of net importer countries whilst Brazil, Indonesia, Malaysia, Russia and South Africa would be more vulnerable. With lower prices meaning less foreign currency being exchanged for the local currency downward pressure is placed on the exchange rate creating inflationary pressures on the wider economy as well as increasing the current account deficit. This leads to a tendency for those countries' central banks to raise interest rates to attract capital and defend their currencies, but at the risk of applying the brakes to economic growth and worsening their debt position.

This leads on to the third theme which is affecting confidence, namely the impending rise in U.S. interest rates. The use of the word 'impending' here means something that is likely to change very soon, but has also been likely to change very soon for a number of years. The Federal Reserve met on 28th October and voted 8 to 1 to keep rates at the same level, which surprised very few but it did change its rhetoric slightly causing many commentators to gravitate towards a December rise. The

U.S. central bank has been criticised of late for its tendency to move with the current economic weather rather than committing firmly to the underlying fundamentals. On one hand there is no connection between the current level of unemployment and the current interest rate - widely held economic policy would suggest they have an inverse relationship but, on the other hand, inflation is below target and the currency is already strong to the point that it is impacting export led manufacturers.

If a small issue is talked about enough it becomes a big issue. When the largest economy in the world decides it needs to change the direction of its monetary policy then the consequences must be considered, especially when rates have not risen for almost a decade. The extent to which the subject has been discussed and hypothesized about in every corner of every market, newspaper or saloon bar may distort the true significance of this first step. American policymakers repeated say that it is not the timing of the first rise which is important but the trajectory that it follows over the coming years. The issue for the investor, as is commonly the case, is that risks arise when sentiment trumps economics.

At some point the United States will raise interest rates. The Federal Reserve has a dual mandate. Firstly, steering the economy towards stable inflation and, secondly, promoting maximum employment. On the latter, the US economy has delivered well with the US unemployment level falling consistently to 5.1% at the end of September. In October 2009 it was 10.0%. As Stanley Fischer, the Fed's Vice Chairman, said in August "The problem is not with the part that's unusual in the dual mandate, namely employment, that's doing fine. It's with the inflation part." The inflation rate has spent most of 2015 at or around 0.0%, influenced by the drop in energy prices but the Labor Department said that September's core consumer price inflation, which excludes volatile elements such as energy and food prices, climbed to 1.9% in September, ahead of forecasts and in line with the Fed target of 2.0%.

Recent repeated bouts of volatility in risk markets suggest that predicting a short term direction is very difficult. Most notable of these episodes was the so called 'taper tantrum' in the summer of 2013. We are now over two years past that date and still find ourselves largely at the same point where what would be an event that in itself has limited economic consequence has assumed an outsized and exaggerated significance. Traditional economic thinking, something which does not always apply at this time, would say suggest that as demand increases, prices will rise, inflationary pressures will grow and interest rates will be forced to rise to keep inflationary pressures in check - 2% per annum is a commonly used target as representing a healthy level of price inflation. This demand led inflation would be seen as a consequence of a healthy, growing economy which would, in turn, imply that companies' goods and services will be in greater demand. All other things being equal, this would lead markets higher. The taper tantrum, which caused bond and equity markets to fall sharply, illustrated the sensitivities around this subject. Markets always react most dramatically to completely new news - an example would be the recent revelations at Volkswagen but, in the case we are considering here, numerous years of waiting for the inevitable rise does not seem to have reduced the potential scale of reaction to something that many commentators would consider overdue.

It is important to remind oneself that current interest rate levels are highly unusual and the period of time over which this policy has prevailed shouldn't cloud our sense of perspective on these monetary conditions. A degree of concern must remain around the fact that it has been necessary for interest rates to be brought to more or less zero and kept there for such a considerable time. Few commentators would have predicted accurately how long monetary policy would have needed to be kept so loose. At a time of low confidence, falling demand and high indebtedness, low interest rates are the prescribed medicine. The theory is that the reduced cost of debt - existing and potential, will encourage consumption by individuals and capital investment by companies. This will kick start economic growth, engender confidence in the economy and develop into a self sustaining recovery. The United States, with the United Kingdom just behind, would probably be the two leading economies where this is closest to being the truth with consumer confidence being relatively buoyant in both countries. Whether such low rates have triggered capital spending by companies is less clear. A Standard & Poor's report in August stated that the world's top spending companies are set to cut back on capital investment in 2015, for the third year in a row. Their survey of the top 2,000 private and public companies found that capital expenditure (capex) by non financial corporations is set to fall by 1% in 2015 and by 4% in 2016. A rise in capex is seen as a key component of future economic growth as investment contributes to efficiencies and boosts productivity. Part of the fall in capex can be attributed to the favoured policy of many companies to buy back their shares and return funds to shareholders through dividends. This has been particularly been the case in US and Japan with European companies playing catch up. This is far from the whole picture, of course, and the fall in commodity values, especially oil, has led to a massive downscaling in exploration and investment generally. Putting the scale of this into proportion, by excluding energy and materials, global capital spending is forecast to rise 8%.

The hope is that an exaggerated sense of expectation exists as a consequence of too many press column inches filled with speculation. Historically, emerging markets have suffered when the dollar has been strong and interest rates rising. We have to go back to 2006 to see the end of the last period of US dollar interest rate rises and there have been 12 periods of rising interest rates in the United States since the Second World War, which on average have lasted 22 months with an average rise in rates of 4.95 percentage points from start to finish. The lowest starting point in a period of rising rates was in 2004 when rates started at 1% and over a 24 month period rose to 5.25% and the most extreme period was between 1976 and 1980 when the Fed Funds rate rose from 4.75% to 20.0%. The past is nearly always used as a point of reference but is seldom an accurate guide to the present. On one hand, the nine years over which we have experienced such historically low rates would suggest there is a heightened propensity for rates to normalise. On the other hand, the prospects of rates rising to, say, 5% over a period of three years would strike fear into large parts of many financial markets, particularly bonds, emerging markets and, especially, emerging market bonds. For that reason, if no other, the Fed has and will probably continue to move with great caution. September's decision not to raise rates raised some eyebrows as Ms. Yellen explained that market volatility influenced their decision not to make the first rate rise saying "The situation abroad bears close watching". It surely must be right not to ignore the recent economic weather; though far from its dual mandate and with exports to China representing less than 1% of US GDP it is difficult not to reflect on what a 1,800 point one week fall in the Dow Jones Industrial Average means to investors.

Interest rates are at the lower bound and have been for many years more than anyone would have expected. Levels of economic growth have failed to reach the pre crisis levels despite the low for longer policy and we now need to face up to the prospect of interest rates normalising. This will add cost to the indebted, in favour of the lender. We do, unfortunately, find ourselves at a point where aggregate levels of debt are higher than at any point in the past and the ability to deal with changes to the costings of that debt will vary greatly across the globe. The least credit worthy risk becoming the even more vulnerable. Emerging markets, where borrowing is often in foreign hard currencies, will face higher interest costs as well as downward pressure on their currencies, which will only serve to compound the negative effect. Those countries with increasingly expensive debt will be forced to raise domestic interest rates to defend their diminishing currencies which will contribute further to the escalating cost of debt and act as a brake on economic growth. A central issue is that trade is global and the world is one economic unit, but interest rates tend to be set in each country's national interest. In the case of the US, where these concerns are most relevant, it would be hard to see the Federal Reserve justifying its interest rate setting policy based on consequential effects in distant countries; the only exception would be if the Fed forecast that the effects would eventually be so significant as to greatly affect global trade or stability and, ergo, the United States.

Looking solely at developed markets, the United States and the United Kingdom now find themselves in a different phase of the economic cycle from the European Union (when viewed as a bloc) and Japan. There are economic similarities between the two English speaking countries that contrast with Europe and Japan. The US and UK both started their quantitative easing programmes early on in the financial crisis and ended their monetary expansion at around the same time. Whilst the timing of any interest rate rise is the subject of much conjecture, there is broad agreement that both will need higher interest rates in the near future. Again, it should be highlighted that current interest rate levels are at a level that have never been experienced before and given that it is indebtedness, in various guises, that has been a large component of this financial crisis it is no surprise that low interest rates have been a large component of the medicine. In the last eighteen months two factors have contributed to the debate on rate rise timing and both, fairly clearly, have inclined policymakers to delay. Firstly, energy prices and commodity prices have collapsed. Over supply for a reduced level of demand will have a predictable effect on price. Added in to the mix is a stand off between producers who wish to stake a claim on future market share by outmuscling higher cost and, therefore, weaker producers. An oil price of around $50 means very different things to each oil producer around the globe. Secondly, and contributing to the first point, China is experiencing a marked slowdown. It was always clear that its rate of growth was unsustainable but recent market volatility emphasises the uncertainties around what that might mean. Both have been disinflationary, to differing degrees, with energy being a direct component of Consumer Prices Index calculations in the form of housing and transport costs. Being a year on year measure of rises and falls in prices, any one off change will figure in twelve monthly calculations and, with the sharp drop in the oil price in 2014, its negative effect on CPI will shortly be excluded. Indeed, any recovery in the price may soon be contributing to a rise in the CPI.

Policymakers in many countries especially emerging markets face difficult policy trade-offs in the light of US interest rates rising. Capital will always seek a return and, in this world of highly international markets, cross border flows of capital are subject to significant changes in response to relatively small input changes. Countries most vulnerable to changes in capital flows will be those where existing capital flows are funding the economic status quo, namely those countries which import more than they export and so the downward pressure on their currency is offset by capital attracted to the currency creating demand for it. For some time a ‘fragile five’ have been conveniently grouped together, being five developing countries which have been seen to be vulnerable to a withdrawal of foreign capital at times of tighter liquidity. Brazil, Indonesia, India, Turkey and South Africa all saw their currencies weaken during the taper tantrum in the summer of 2013 and remain at risk today. To this list can now be added countries such as Colombia and Mexico where oil represents a major export, particularly for government revenues. Colombia, for example, has a current account deficit of 5.8% of GDP which needs to be funded by capital inflows. Its currency, the peso, has fallen in value by 36% against the US dollar in the past 12 months. Mexico is also seen as vulnerable as it also has a funding gap but has very limited foreign exchange reserves to support that funding gap. This would contrast with Russia whose reserve coverage ratio - its foreign exchange reserves divided by its funding gap is around seven years, significantly higher than Mexico’s 1.6. A country in such a position faces a choice between cutting its interest rate with the aim of stimulating its struggling economy and boosting aggregate demand or raising interest rates to make its currency more attractive. The two options have negative effects which accompany the intended outcome as lower rates can stoke inflation and higher rates can stifle a fragile economy.

The starting point of this memorandum was the IMF's World Economic Outlook and the observation that its assessment that a cautious stance rather than a sense of alarm is appropriate at this time. We at Meridian would echo that sentiment and refer the reader to previous memoranda where we have warned of negative quarters for equities and the need to be realistic about returns in the short term, following several highly profitable years. We remain of the view that equities continue to present a strong investment case over the medium to long term and we would remind investors of the ever present need to consider such investments as a long term commitment. Bonds, in our view, remain significantly overpriced.