meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Overall, this has been a fairly benign quarter for investors, with a very modest improvement in equity markets, albeit with a considerable divergence of performance between different countries and regions. Bonds have been mixed whilst currency markets have been quite quiet, with sterling tending to weaken. In the commodity markets, the onset of a second wave of Covid-19 has hit the oil price on expectations of lower demand.

The tables below detail relevant movements in markets :

International Equities 31.07.20 - 30.10.20

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.2	+0.6	-0.9	+0.6
Finland	N/C	N/C	-1.5	N/C
France	-3.7	-3.7	-5.1	-3.7
Germany	-6.0	-6.0	-7.4	-6.0
Hong Kong, China	N/C	+1.5	N/C	+1.5
Italy	-7.3	-7.3	-8.7	-7.3
Japan	+6.2	+9.0	+7.4	+9.0
Netherlands	+0.2	+0.2	-1.3	+0.2
Spain	-6.5	-6.5	-7.9	-6.5
Switzerland	-3.8	-3.1	-4.5	-3.1
UK	-4.5	-4.5	-5.9	-4.5
USA	+0.7	+2.2	+0.7	+2.2
All World Europe ex UK	-3.6	-3.6	-5.0	-3.6
All World Asia Pacific ex Japan	+3.3	+5.5	+3.9	+5.5
All World Asia Pacific	+4.3	+6.7	+5.1	+6.7
All World Latin America	-6.5	-10.7	-12.1	-10.7
All World All Emerging Markets	+2.6	+4.2	+2.7	+4.2
All World	+0.4	+1.8	+0.3	+1.9

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -2.3%

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

Currency	31.07.20	30.10.20
Sterling	0.10	0.26
US Dollar	0.53	0.87
Yen	0.01	0.03
Germany (Euro)	-0.53	-0.63

Sterling's performance during the quarter ending 30.10.20 (%)

Currency	Quarter Ending 30.10.20
US Dollar	-1.0
Canadian Dollar	-1.7
Yen	-2.2
Euro	+0.1
Swiss Franc	-0.7
Australian Dollar	+0.6

Other currency movements during the quarter ending 30.10.20 (%)

Currency	Quarter Ending 30.10.20
US Dollar / Canadian Dollar	-0.6
US Dollar / Yen	-1.1
US Dollar / Euro	+1.2
Swiss Franc / Euro	+0.8
Euro / Yen	-2.3

Significant Commodities (US dollar terms) 31.07.20 - 30.10.20 (%)

Currency	Quarter Ending 30.10.20
Oil	-12.6
Gold	-4.5

MARKETS

Overall, international equity markets have shown a very modest total return over the last quarter. The performance was dragged lower by weakness at the end of the quarter, occasioned by a resurgence of Covid-19 cases and the resulting lockdowns in parts of Europe.

In local currency terms, the FTSE All World Index returned +0.4%, in sterling terms +1.8%, in US dollar terms +0.3% and in euro terms +1.9%. Looking at local currency returns first, the outstanding performer was Japan, with the FTSE Japan Index returning +6.2%. There were also relatively good performances from the FTSE All World Asia Pacific ex Japan Index, +3.3%, and the FTSE All World All Emerging Markets Index, +2.6%. On the other hand, there were relatively poor performances from the FTSE All World Latin America Index, -6.5%, the FTSE UK Index, -4.5%, and the FTSE All World Europe ex UK Index, -3.6%. The FTSE USA Index returned +0.7%, marginally higher than the return on the FTSE All World Index. With currency movements quite modest this quarter, sterling returns on the various indices were not greatly different. The strength of the yen meant that the return on the FTSE Japan Index in sterling terms was +9.0%. The sterling returns on the FTSE All World Asia Pacific ex Japan Index and FTSE All World All Emerging Markets Index also increased relative to local currency returns to +5.5% and +4.2% respectively. With the US dollar slightly stronger against sterling, the return on the FTSE USA Index was raised to a very respectable +2.2%. On the negative side, weakness in Latin American currencies meant that the sterling return on the FTSE All World Latin American Index was -10.7%.

Whilst fixed interest yields, of course, remain very low, they did rise towards the end of the quarter in the UK and USA. Taking ten year government bonds as the benchmark, the gross redemption yield on the ten year UK government bond rose by 16 basis points to 0.26% and, on the US Treasury bond, by 34 basis points to 0.87%. The gross redemption yield on the Japanese Government Bond rose by 2 basis points to 0.03%, but that on the German Bund fell by 10 basis points to -0.63%.

In the foreign exchange markets, sterling was generally weaker. Against the yen, it fell by 2.2%, against the Canadian dollar by 1.7%, against the US dollar by 1.0% and against the Swiss franc by 0.7%. On the other hand, it rose by 0.6% against the Australian dollar and 0.1% against the euro.

In the commodities market, oil, as measured by Brent crude, fell by 12.6% and gold, after a strong run, fell by 4.5%.

ECONOMICS

As this is written, a second wave of Covid-19 is sweeping through Europe and the USA, forcing a number of governments in Europe to step up measures to try to control the spread of the virus including more lockdowns, albeit with different profiles to those earlier this year, as attempts are made in some countries to try to mitigate the most damaging economic effects. Economic prospects for the final quarter of 2020, and probably the first quarter of 2021, have been damaged. Yet before this, the economic news, whilst dreadful, was not quite as bad as it had been.

In October, before the severity of the second wave of Covid-19 became apparent, the IMF had published new economic projections in its World Economic Outlook. Compared with last June's projections, it forecast negative growth of 4.4% for the world economy, an improvement of 0.8%. Within that figure, it projected negative growth of 5.8% for Advanced Economies, an improvement of 2.3%. In this sector, it foresaw a much less bad outcome in the USA, with an economic contraction of 4.3%, a very large improvement of 3.7% compared with last June's forecast. The performance of the euro area, whilst very poor, with negative growth of 8.3%, was 1.9% better than its earlier forecast. Within the eurozone, the forecasts for Italy and Spain remained very bad at -10.6% and -12.8% respectively. For Italy, this represented an improvement of 2.2%, but there was no change on the Spanish projection. Germany and France, at -6.0% and -9.8% respectively, showed improvements of 1.8% and 2.7% respectively. Japan's projection at -5.3% reflected an improvement of 0.5% compared with June. The UK's result, whilst expected to be relatively poor at -9.8%, was 0.4% less bad than the June projection.

The projection for Emerging Markets and Developing Economies remained less bad than that for Advanced Economies, although in absolute terms it was 0.2% worse. This was mainly due to a sharp deterioration in the outlook for India where the negative growth forecast of 10.3% this year was 5.8% worse than in June. This was not able to be offset by the 0.9% improvement in the forecast for China which is for 1.9% growth. Although the severe deterioration in the outlook for India has reduced the outlook for Emerging and Developing Asia to negative growth of 1.7%, it is still a relatively strong performance and, at the time of writing, Asia is outperforming the West quite noticeably. Although the Covid-19 pandemic is hitting India really hard, China and a number of other Asian countries have the virus under much better control and are able to keep their economies much more open than Western ones.

We have now reached the stage where figures have lost the power to shock. A billion here, a trillion there, so what? Central banks and governments have used or created vast sums of money to keep their economies from collapsing and it is becoming very difficult for finance ministers or central banks to invoke any sense of discipline. They may warn about the future and the financial cost of these monetary and fiscal rescues, but it seems that no one is listening. As the second wave engulfs some countries, the taps have had to be turned on again and it is difficult for finance ministers to resist spending pledges and they are painted as hard hearted if they do.

For the moment, however, governments are using extreme fiscal policy to try to steady their economies and are borrowing mind blowing amounts of money. In its September review, the OECD produced a very instructive table showing the official estimates of fiscal support as a percentage of 2019 GDP in different countries, broken down by three categories which are, firstly, direct support for workers, firms and healthcare, secondly, tax deferrals and, thirdly, guarantees and loans.

The USA's measures, although obviously extremely large in absolute terms, in relative terms are at the lower end of the scale. In the first category above, direct support is around 7% of GDP, tax deferrals, the second category, around 1% of GDP and guarantees and loans, the third category, around 5% of GDP. Germany, on the other hand, whilst eschewing tax deferrals, has implemented direct support, the first category above, amounting to around 12% of GDP, whilst guarantees and loans represent an astonishing 30% of GDP. Italy's support has been huge, too. Direct support is over 12% of GDP, tax deferrals about 13% of GDP and guarantees and loans around 30% of GDP. Japan, too, is at the upper end of the range. Its direct support has amounted to around 15% of GDP, tax deferrals almost 5% of GDP and guarantees and loans around 22.5% of GDP. In the UK, direct support has amounted to about 7% of GDP, tax deferrals to around 1.5% of GDP and guarantees and loans to about 15% of GDP. These are extraordinary levels of support, necessitated by the severity of the crisis, and we will come to the long term implications later. At its simplest level, governments' fiscal support has limited the short term damage to the world economy and will have accounted for part of the stock market's recovery since last March. September now seems a long time ago given the upsurge in cases and renewed lockdowns in some countries so the percentages will be greater now. The figures are extraordinary.

Even before the Covid-19 crisis, we had been emphasising the importance of ultra loose fiscal policy in determining the course of bond and equity prices. Through additional quantitative easing (QE) and even lower interest rates, the monetary taps have been turned on and, of the major central banks, only the People's Bank of China's balance sheet has not increased in size substantially this year. For example, the Federal Reserve's balance sheet has increased in size by about 75% so far this year, that of the ECB by over 50% and that of the Bank of Japan by about 25%. The Bank of England's balance sheet has increased by about 60% so far this year. The central banks have been doing whatever they can to ensure liquidity in the system and very low borrowing rates as the explosion in the size of their balance sheets show and, as after the GFC, some of this liquidity has seeped into asset prices, keeping bond prices firm and helping equities to recover after their sharp fall in late February and through most of March. Most central banks are providing unprecedented monetary support and, together with fiscal policy, which we have just discussed, they are doing whatever it takes to try to stabilise the world economy.

These extraordinary figures have been met with insouciance by the stock market. Broadly speaking, international equity indices are unchanged so far this year, although there are wide variations in performance between different countries and sectors. The UK, for example, has performed poorly, whilst China, the USA and Japan, amongst others, have performed well, with the Chinese market being outstanding. There has, of course, within that overall benign movement, been enormous volatility, with a precipitous fall in the first quarter being reversed in the second quarter, reflecting the sudden and unexpected shock of the pandemic in the first quarter and reflection on the monetary and fiscal measures taken in the second quarter to try to stabilise the position. This is being written just after further lockdown measures were being announced in parts of Europe and the UK. Initially, the markets fell back on the news but are now recovering. This may or may not be significant, but the resilience of markets nevertheless is impressive.

From an economic and market outlook, the current position seems surreal. With astronomical amounts of government debt being issued and huge budget deficits being run, one would expect buyers of fixed interest securities to be demanding much higher interest rates and, in some countries, to see a run on the currency. Yet, amongst the largest economies, this has not happened and, for that reason, the major economic players continue their fiscal expansions and the central banks their extraordinarily loose and unorthodox monetary policy. Buyers of government bonds in the primary market, who might otherwise have baulked at buying bonds on negligible yields, have been confident that the relevant central bank would stand behind them in the secondary market.

It would be nice to think that this state of affairs, whereby governments spend money which they do not have and central banks create money electronically to help indirectly fund the governments' deficit, could continue until the crisis is over and economic activity restored to some sort of normality. The suppression of interest rates by central banks, including the use of negative interest rates, means that servicing the debt has not been problematical, whereas, if normal interest patterns prevailed in these circumstances, an economic crisis would have resulted as higher interest rates seriously damaged a country's finances and made a change of policy inevitable. So, when will the normal laws of economics reassert themselves? After all, in countries like Zimbabwe and Venezuela, use of the printing presses by the central banks has caused hyperinflation as a total loss of confidence in the currency has had a devastating effect on inflation, with ever larger note denominations having to be printed and noughts being lopped off the ends of currencies through devaluation. There are various constraints. We noted earlier, how central banks' balance sheets have ballooned in size this year as a result of the banks purchasing bonds, mainly, but not exclusively, government ones, with electronically created money. The original idea of quantitative easing (QE) was that, when it was wished to tighten monetary policy, the central banks would sell assets back to the private sector. Given that central banks would have bought many of these bonds on minuscule yields, the effect of tightening monetary policy would be to raise interest rates and, therefore, tightening monetary policy in this way could cause central banks heavy losses as they sold bonds at lower prices than they paid for them. In normal times, the huge expansion in central banks' balance sheets might have been expected to be highly inflationary. The additional reserves which the banking system held with their central banks, if they were mobilised by raising lending and increasing the speed at which the money passed through the economy, could be inflationary as a result of an increase in the velocity of circulation. This has not happened so far, but, if it is possible to imagine better times in the current circumstances, with confidence amongst businesses and individuals increasing, inflation could become a problem. Imagine a very simplistic example of an increased amount of money in circulation and a finite amount of goods available for sale, and the expectation would be that higher inflation would result. This is the outcome that many would have expected in the light of the printing presses having been used so frequently. For now, of course, confidence is low, so the demand for loans is weak, but it must be considered a strong possibility that inflation becomes an issue. If it does, it is not a problem which can be ignored by central banks as they set monetary policy. Higher interest rates and the reversal of QE to tighten monetary policy would be the policy response. Reversing QE, meaning the sale of bonds which were purchased, often at lower interest rates, would entail losses for central banks, as indicated above, whilst budget deficits would start to feel the pain of higher debt servicing costs which might have to be addressed by tighter fiscal policy, either in the form of higher taxes and/or reductions in government spending, both of which measures have a negative effect on economic growth.

Looking at the current scenario from the perspective of fixed interest investors, there must be some concern. On the positive side, they can feel fairly sure that central banks will continue to keep interest rates very low for the foreseeable future, indeed most have said that, so, even if they feel that the market is significantly overvalued on fundamentals, as many investors must do, their short term worries will be limited. There will be some concern, expressed in medium and long dated US Treasuries, that the Federal Reserve's more relaxed view on inflation in that, in setting policy, it will look at average inflation rates rather than absolute rates. This will mean that it will tolerate inflation rates above 2% if it does not push up the recent average above that level. US Treasury yields pushed up higher on that news reflecting the damage that higher inflation does to fixed interest prices in normal circumstances. On the other hand, eurozone bond yields have remained very low or in negative territory as a result of ultra aggressive ECB policies and very low inflation. But ultimately there must be a limit to the extreme nature of monetary policy currently being followed. Buyers of fixed interest securities in the secondary market may draw the line on what level of yields they are being offered, feeling that they can no longer accept the risk of sometimes buying securities on negative real yields. The chain of confidence which is currently linking the major currencies and enabling them to follow collectively similar monetary policies could be broken if one of them comes under pressure in the currency markets. That currency would be unable to sustain current interest rate levels as it fought to attract investors. It is unlikely that interest rates in other major currencies would be unaffected. Given that it is almost impossible to believe that there is any medium or long term value in fixed interest securities with negative or minimal yields, there must be a concern that the chain will break at some stage. Once confidence is lost, it would be fanciful to think that the relevant central bank could create limitless amounts of money to effectively fund the government's debt.

For equities, the picture is somewhat different, in our view, being rather better over all time periods, except the very short term one, where, as always, it is impossible to predict with any degree of accuracy what markets will do. As with fixed interest securities, they have been buoyed by the liquidity arising from monetary policy being so easy. As in the aftermath of the Global Financial Crisis (GFC) 13 years ago, the policy reaction, very loose monetary policy, has boosted asset prices as it was then meant to do and has done now, although the policy outcome this time would not have been the primary one targeted. After the GFC, using monetary policy to raise asset prices was meant to engender a feelgood factor which would encourage spending and economic activity. On this occasion, with parts of the world economy closed down by government decree, the monetary and fiscal measures used were to support individuals and businesses and help them to survive the lockdown. Although the sharp recovery in share prices from the end of March may have been thought by some to be politically embarrassing, given the difficulties so many people were experiencing as a result of the coronavirus, there has been a beneficial side effect in that, if the stock market had collapsed, the situation would have been infinitely worse. The recovery in share prices has also made it easier for some companies to raise money to see them through the crisis and even to plan for expansion with some opportunistic acquisitions. Overall, the wealth effect, arising from the recovery in share prices, will have had some beneficial effect on the world economy, if only to avoid an even worse outcome.

So, the enormous amount of liquidity created has seeped into share prices and bonds. That is to be expected. A more fundamental reason is that the current very low or negative interest rates raises the attraction of equities and can justify price/earnings ratios in excess of what normally would have been considered reasonable. The discount rate applied to future earnings, using the risk free rate, means the net present value of these earnings is much higher than it would have been in a more normal interest rate environment. Equities nearly everywhere offer a higher dividend yield than the yield available on fixed interest securities, even after dividend cuts, which are particularly noticeable in Europe. With central banks committed to keeping interest rates very low for the foreseeable future, the relationship is likely to continue to be supportive for equity prices. The risk for fixed interest securities is that when, eventually, interest rates start to revert to mean, the risk to capital values as one moves along the yield curve is considerable and, for those who bought fixed interest securities at these very low or negative yields, the losses may not be recoverable. At least for equities, which would be affected by a meaningful rise in interest rates, the prospect of recovery and a further advance would be there. The range of attractive investment options, beyond shares, is very limited at present.

Of course, the broad generalisation about equities must be qualified both as to the type of equity (value or growth), areas of business, which might well be related to this point, and geographical area. The wide disparity in performance so far this year reflects these considerations. By type of equity, value has endured a long period of underperformance, whereas growth has performed very well. So, for example, if we look at the USA as one of the best performing markets this year, the S & P 500 in US dollar terms has risen about 6.5%, reflecting the broad market, whilst the technology heavy NASDAQ index has risen about 29%. China has performed very well with the CSI 300 Index up about 25% this year, some of it reflecting growth stocks and some reflecting the relatively good performance of the Chinese economy, which has also been attracting foreign investors to its market. On the other hand, to take two of the worst performing markets this year, the UK and Spain, down around 23% and 24% respectively, they have been weighed down by value stocks, banks and oil companies, for example. The divergence of performance between value and growth stocks has become so extreme that it is tempting to try to take a contrary view. In practice, it is prudent to take a balanced view because some of the weakness in value stocks is a reflection of the unusual economic conditions caused by the coronavirus. Take banks, for example. Very low, or negative, interest rates threaten their net interest margins. Borrowers expect the interest rate which they are charged to fall when interest rates are reduced, whilst depositors do not expect to see negative interest on their deposits. Also, the fact that regulators in Europe have forced banks to omit their dividends has, temporarily, reduced the attraction of a sector which, historically, would have attracted income investors. Whilst, in some countries, the bad debt situation of banks has been improving in the latest quarter, we will need to see what happens when government support measures for the economy tail off. But good quality banks in areas like Europe sell for a large discount to book value and a value investor will always be interested in this fact. The ban on dividends in some European markets has, at least for the moment, detracted from their investment attractions. Another value sector, oil, has been hit hard by the pandemic induced fall in demand which has pushed down the price of oil very sharply, forcing companies like BP and Royal Dutch Shell to cut their dividends. It would be easy to give up on these sectors, but a prudent investor will not want to have an overconcentrated portfolio in growth stocks at the expense of value stocks because, at some stage, sentiment will turn. Royal Dutch Shell, after cutting its dividend by two thirds, has started to raise its dividend again, albeit modestly.

The divergence of markets this year, both by type of stock and geographically, emphasises the importance of diversification. We always emphasise how important geographical diversification is and the widely differing performances of markets this year has made the point strongly. Home bias should be avoided, where possible, and UK investors who have an overweight position in the UK market relative to its weighting in the world market will have experienced an underperformance so far this year compared to a world index. The US stock market, for instance, is around fourteen times the size of the UK stock market and, so far this year, the difference in performance is around 30%, a staggeringly large figure over ten months.

Our conclusion from of all this is that, even though interest rates are likely to remain very low for the foreseeable future and, therefore, the short term risk may seem manageable, government bonds yielding between -0.63% and 0.87%, as shown by the table of four ten year government bonds in the table on the second page, offer no medium or long term value and are susceptible to severe capital losses if there is a move towards historically more normal levels. Even though the world economy is experiencing a severe recession this year, having a stake in real assets through equities is likely to provide the best long term returns out of the main asset classes. The very low interest rate environment heightens their relative attractions, as outlined earlier. We discussed the value/growth dichotomy and the effect which the Covid-19 induced recession is having in some sectors. Consideration should be given to which sectors might be permanent beneficiaries, to others which have been hard hit by the recession but which are viable businesses which can recover once some normality has been restored to economic life and to those sectors where life will never be the same again. An internationally diversified equity portfolio, where mandate considerations permit, is our favoured policy.

We have reached this far in the review without mentioning the US elections and Brexit. We can perhaps leave the latter for at least another month because we do not know the final outcome of negotiations and our feeling is that the Covid-19 induced recession and its consequences should loom much larger in the UK's and EU's economic outlook.

As this is written, we are not fully certain of the outcome of the US elections but, assuming that Joe Biden assumes the Presidency in January, the Republicans hold the Senate and the Democrats retain the House of Representatives, so that Congress is split, that is not an unsatisfactory result. It should limit the possibility of extreme measures being legislated and, not meaning to be cynical at all, the less some governments do the better. Economies can run themselves better without micro management. We will obviously be concentrating on the US political scene much more in future reviews when we know the whole picture. It is important to emphasise, however, that, whilst the election for the President captures most of the attention, the checks and balances in the Constitution mean that Congress is very powerful. If control is divided, as it looks likely to be for at least the first two years of the Presidency, then domestic policy measures are likely to be limited, giving some useful clarity for investors. This is written just after election day. Wall Street has been very strong for the reason mentioned just now, the belief that there will be a split Congress. Investors, if that turns out to be the case, have a better line of sight because of the likely lack of significant action in domestic policy. It looks, though, as if we will have to wait until January for the final Senate composition because of two run offs in Georgia.

We cannot predict short term market movements and, as always, we try to take the medium and long term view which favours equities and sees fixed interest securities as very expensive. Geographical diversification remains of paramount importance. If we had to guess what might determine short term market movements, it would be evidence of a successful vaccine to tackle Covid-19. Even though markets have held up very well this year against such a dreadful background, good news would be likely to propel the markets higher. If there is no good news, there will have to be a reappraisal of how to adjust to Covid-19 being around for the medium term and how economies can work round that. This obviously would create more uncertainty for markets.