meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

After a strong first half of 2019, international securities' markets built on that strength and consolidated their position in the third quarter, with bonds, equities and gold all moving higher, an unusual combination of events due mainly, we believe, to the influence of very loose and unorthodox monetary policy.

The tables below detail relevant movements in markets :

International Equities 28.06.19 - 30.09.19

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+2.5	+1.7	-1.5	+2.9
Finland	+2.6	+1.5	-1.8	+2.6
France	+2.9	+1.7	-1.5	+2.9
Germany	+0.5	-0.7	-3.8	+0.5
Hong Kong, China	-10.8	-8.2	-11.1	-7.2
Italy	+4.5	+3.4	+0.1	+4.5
Japan	+3.5	+6.6	+3.2	+7.8
Netherlands	+5.9	+4.7	+1.3	+5.9
Spain	+0.7	-0.4	-3.6	+0.7
Switzerland	+2.5	+3.5	+0.2	+4.7
UK	+1.2	+1.2	-2.1	+2.3
USA	+1.6	+4.9	+1.6	+6.1
All World Europe ex UK	+2.3	+1.6	-1.6	+2.8
All World Asia Pacific ex Japan	-2.3	-0.8	-3.9	+0.4
All World Asia Pacific	-0.1	+2.0	-1.2	+3.2
All World Latin America	+2.8	-1.0	-4.2	+0.1
All World All Emerging Markets	-1.8	-0.5	-3.7	+0.6
All World	+1.3	+3.5	+0.2	+4.6

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +6.2%

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

Currency	28.06.19	30.09.19
Sterling	0.79	0.39
US Dollar	1.99	1.66
Yen	-0.15	-0.28
Germany (Euro)	-0.40	-0.57

Sterling's performance during the quarter ending 30.09.19 (%)

Currency	Quarter Ending 30.09.19
US Dollar	-3.2
Canadian Dollar	-2.1
Yen	-2.9
Euro	+0.9
Swiss Franc	-1.1
Australian Dollar	+0.6

Other currency movements during the quarter ending 30.09.19 (%)

Currency	Quarter Ending 30.09.19
US Dollar / Canadian Dollar	+1.1
US Dollar / Yen	+0.3
US Dollar / Euro	+4.2
Swiss Franc / Euro	+1.9
Euro / Yen	-3.8

Significant Commodities (US dollar terms) 28.06.19 - 30.09.19 (%)

Currency	Quarter Ending 30.09.19
Oil	-8.3
Gold	+6.2

MARKETS

Both equity and bond markets moved higher over the quarter. In the equity markets, the FTSE All World Index returned +1.3% in local currency terms, +3.5% in sterling terms, +0.2% in US dollar terms and +4.6% in euro terms. Looking at local currency returns first, the divergences against the FTSE All World Index were generally quite small. The main divergence for obvious reasons was the FTSE Hong Kong, China Index which returned -10.5%. In sterling terms, the highest return was seen from the FTSE Japan Index which returned +6.6% as currency movements raised the return. The FTSE USA Index also showed an above average return at +4.9%. Underperformances were seen from the FTSE All World Latin America Index, -1.0%, and the FTSE All World All Emerging Markets Index, -0.5%.

In the international bond markets, gross redemption yields, as measured by ten year government bonds, continued to fall to even more extraordinary levels. The yield on the UK gilt fell by 40 basis points to 0.39%, on the US Treasury by 33 basis points to 1.66%, on the Japanese Government Bond by 13 basis points to -0.28% and on the German Bund by 17 basis points to -0.57%.

In the foreign exchange markets, sterling strengthened against the euro by 0.9% and against the Australian dollar by 0.6% but, elsewhere, it was weaker. Against the US dollar, it fell by 3.2%, against the yen by 2.9%, against the Canadian dollar by 2.1% and against the Swiss Franc by 1.1%.

In the commodity markets, oil, as measured by Brent crude, fell by 8.3%, whilst gold continued its good performance, rising by 6.2%, as some of its perceived benefits in uncertain times came to the fore.

ECONOMICS

There is little doubt that the international economic situation is deteriorating. The proximate cause of this is the dispute over trade between the USA and China and a wider problem is the inability of monetary policy to kick start economic growth as ever more desperate measures are taken to spur economic activity, notably in the eurozone. This is a narrative which we have outlined in our reviews for many months now, but the story does not change. The outcome is surreal with strong international equity markets so far in 2019 and vast swathes of the international bond markets selling on negative gross redemption yields. It is not supposed to be like this. The level of bond yields to an observer who had been cut off from market and economic news for many years would suggest that the international economy was experiencing an economic depression rather than very modest economic growth, as at present. Such an observer would find present bond and equity market prices very puzzling and not at all consistent with what the text books would say.

As it happens, the OECD has just released its Interim Economic Outlook and, in line with most forecasters, has been reducing its growth estimates for the world economy. Its estimate for world economic growth in 2019 is now 2.9%, a reduction of 0.3% from its May figure of 3.2%. Likewise, for 2020, it has brought down its forecast by 0.4% to 3.0%. It should be emphasised that these are not disastrous levels of growth, but one would not want to see a continuation of the trend to lower forecasts each time an organisation updates its previous one. World growth in 2018 was 3.6%. Breaking this top level forecast down, the G20 nations are now expected to grow by 3.1% this year and 3.2% next year, a reduction over last May's estimates of 0.3% and 0.4% respectively. The only countries which have seen their growth forecasts raised since last May for this year are Canada by 0.2% to 1.5%, Japan by 0.3% to 1.0% and Turkey by 2.3% to -0.3%. There are only two countries in the G20 where the 2019 forecasts are unchanged and they are France and Italy at levels of 1.3% and 0.0% respectively. For 2020, the only two G20 countries where the OECD has left its forecasts unchanged are Japan and Turkey at 0.6% and 1.6% respectively. Back to the OECD's forecasts for 2019, however, and the OECD sees the all important US economy growing by 2.4%, a downgrade of 0.4% from last May. For 2020, it sees 2.0% growth, a downgrade of 0.3%. These are not bad figures, but not what the President would want to see in the Presidential election year. As we see when we come to look at it in more detail, the eurozone is where the most concern resides at present. Overall, the OECD has reduced its forecast by 0.1% this year to 1.1% and by 0.4% next year to 1.0%. However, the downgrades for Germany, the eurozone's powerhouse, are quite striking, this year by 0.2% to a lowly 0.5% and next year by an enormous 0.6% to 0.6%. The comparison with France is interesting where the expectations at 1.3% for this year and 1.2% next year, although modest in their own right, are significantly better than its close neighbour. Elsewhere in the G7 countries, the OECD has made modest reductions in its forecasts for the UK. For 2019, it has reduced its growth estimate by 0.2% to 1.0% and by 0.1% in 2020 to 0.9%. Interestingly though, if these figures are correct, they will be noticeably higher than for Germany, which is interesting in a Brexit context. Outside the G7, the OECD's forecast for China has been trimmed this year by 0.1% to 6.1% and for next year by 0.3% to 5.7%. The downgrades for India have been much sharper, by 1.3% this year to 5.9% and by 1.1% next year to 6.3%. The economic news from India has been disappointing. So, whilst the economic outlook on the evidence before one is not inspiring, it is not that bad. It is the trend of forecasts which is concerning as these have been on a steady downward trajectory.

It is not difficult to understand why economic forecasts are being regularly downgraded. The background has been dominated by the stand off between the USA and China over trade and the imposition of reciprocal tariffs on most items. It represents a power battle for economic leadership between the two countries and, against this background, sound economic arguments against protectionism do not get a hearing. Free trade helps to maximise economic efficiencies and consumer welfare, and the move towards overt and covert protectionism is deeply disappointing. Whatever its problems at the moment, the UK stands out as one of the most enlightened in promoting free trade. However, as a much smaller economy, its influence is very limited. We have outlined in our reviews many times the economic damage which protectionism causes. Tariffs and quotas introduce inefficiencies into the economic system. These may take the form of raising the final prices of goods to consumers and businesses as either inputs become more expensive or the final imported product becomes more expensive. Supply chains become distorted with the most efficient suppliers perhaps losing business to suppliers in other countries which are not as efficient, also raising the cost of imports. For example, US companies are diverting some supplies from Chinese manufacturers to avoid tariffs. The alternatives may or may not be as efficient, but having to change supplier is, at the very least, disruptive. If the reason for imposing tariffs is to protect US manufacturers, say of US steel, it will come at a price, namely higher prices for US products which use steel as an import. This may affect sales, say of US cars, and insofar as it does, those US consumers who buy the cars have less disposable income for such purchases, with a knock on effect on US jobs. For businesses, it introduces uncertainty. Not having a clear picture of economic policy or outcomes from the present dispute is not conducive to investment and productivity growth, which is necessary to drive growth in real incomes. This, of course, is a very simplistic description of the damage which protectionism causes, but it provides the background for the steady reduction in forecasts for international growth. Business confidence is an important determinant of investment so, in this respect, protectionism is very unhelpful. Blame can be attached to both sides in this dispute and the USA has some very legitimate complaints, the argument over intellectual property being one.

It is difficult to know how this stand off will end. Being realistic, neither side can be seen to have lost, so both parties will have to be able to claim some sort of victory from the final result. Economists like to think that they are rational so, if they try to apply their logic to the actions of President Xi and President Trump, they would conclude that it is in the interests of both parties to come to an agreement. In the case of President Trump, facing re-election next year, he will want to see some good economic numbers to put before the voters. In this respect, whilst the economic data from the USA remains generally satisfactory, the forecasts for growth, as we see from the OECD, are coming down. He may consider that his strongest economic card to support his re-election bid is the state of the US economy. It is a fairly uncontentious assumption, and backed up by the current economic data, that the trade dispute is affecting economic growth and that this effect will continue through next year up to the November election date. Insofar as it does, then one must assume that President Trump's re-election prospects will worsen. One can see that, in his regular criticism of the Federal Reserve for not reducing interest rates further, he realises the importance of the state of the US economy to his re-election prospects. Even in this most uncertain of times, it is reasonable to assume that the President will try to reach a deal with China that he is able to sell to US voters as a justification for his action.

What of President Xi? Although he does not have to face the voters like President Trump, he has every reason to try to find a solution because with increased power, which he has accumulated, brings increased scrutiny and the need to keep meeting his economic objectives even with the political system which exists in China. Tariffs are affecting China and the evidence shows that the economy is slowing down. Added to which are the events in Hong Kong which is an unwelcome distraction for President Xi. There is, therefore, also a lot of pressure on China to reach a deal. We live in extraordinary times, so one cannot count on a deal being agreed but, on the basis of what seems rational from both parties' point of view, we believe that this remains the likely outcome and our working assumption for the moment.

The trade dispute is, therefore, a specific issue for investors to consider, but the other main one is a general one, the weakening power of monetary policy to affect economic growth. There are, of course, two levers of economic policy, fiscal and monetary and, since the financial crisis over ten years ago, attention has been focused on monetary policy. This is not to say that fiscal policy has not been used because it has in countries like the USA where an enormous fiscal stimulus was given last year. But let us concentrate on the eurozone, where, along with Japan, monetary policy has been at the most extreme end of the spectrum. Whilst the USA was able to give a large fiscal stimulus last year, the eurozone is constrained by the Stability and Growth Pact which limits the size of a country's budget deficit, amongst other constraints, so monetary policy, under the control of the ECB, has taken the brunt of policy decisions to try to stimulate economic growth within the eurozone. As we can see from the OECD's economic forecasts, the eurozone's economic performance is weak and there are concerns about the largest economy, Germany, where the economic outlook has deteriorated. As a result of the worsening economic outlook, the ECB, in September, has tried a further stimulus to the eurozone economy by decreasing the interest rate on the deposit facility by 0.10% to -0.50%. At the same time, it has said that it "now expects the key ECB interest rates to remain at their present, or lower, levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2%, within its projection horizon and such convergence has been consistently reflected in underlying inflation dynamics". Additionally, the ECB said that net purchases under the asset purchasing programme will be restarted at a monthly pace of €20 billion as from the 1st November and for this to continue for as long as necessary to reinforce the accommodative impact of its policy rates and to end shortly before it starts raising the key ECB interest rates. There are other measures as well but intuitively one feels that, if such extreme monetary policy has not achieved its objective before, it is unlikely that these additional measures are going to make much difference. If businesses and consumers have not decided to raise their investment or spending at current interest rates, then a marginal further reduction is unlikely to tip the balance. The reference to the inflation target is interesting because there are shades of Japan here. The latest consumer price index for the eurozone shows prices to be 1% higher than a year ago. It seems strange to be complaining about a lack of inflation when many investors have experienced years when too high levels of inflation were the concern. In Japan, of course, there were years of deflation and this is an environment where it is difficult to get people to spend, thereby making reasonable economic growth more difficult. It seems that monetary policy has lost most of its ability to be effective and that the returns from further easing, either by interest rate cuts or more quantitative easing, are diminishing.

Unsurprisingly, in the eurozone, talk has turned in some quarters to a fiscal stimulus to complement the current monetary policy. When this suggestion is raised, all eyes turn to Germany, especially as its economy is weakening. The importance of the car industry, at a time when the sector is facing particular challenges, as well as international trade, which is suffering a slowdown as a result of the trade tensions, are economic headwinds for the country. On paper, Germany has substantial room for a fiscal stimulus. Its budget surplus as a percentage of GDP is expected to be around 0.7% this year and its outstanding public debt in 2018 was 60.9% of GDP, pretty well on the Stability and Growth Pact limit. The budget deficit rule is very comfortably met as a result of its surplus. The Netherlands, although a much smaller economy, also runs a budget surplus, 0.6% of GDP is expected this year, whilst its outstanding public debt is 52.4% of GDP. Both countries have very large current account surpluses, estimated at 6.5% in the case of Germany and 9.7% in the case of the Netherlands. There is a constitutional limit in Germany on the size of its structural deficit, 0.35% of GDP, and there has been a cross party consensus up to now on this limit. Now there is growing pressure in Germany to move away from what is called the "black zero" budget and loosen the purse strings. Certainly, there are a lot of things which Germany could usefully spend money on, and infrastructure would be one of them. At a time when monetary policy seems to have run its course, a powerful dose of fiscal activism could be helpful, both for Germany and the eurozone. The size of Germany's current account surplus points to an economic imbalance. From a German aspect, the euro is undervalued and this has helped the country to accumulate large current account surpluses. If it were to loosen the purse strings, it would be an important contribution to a more balanced economic policy in the eurozone.

It is widely accepted that an important reason for the eurozone's disappointing economic performance is structural. A number of the countries suffer from over regulation and inflexible employment markets, as well as the constraints imposed by the single currency in an area which is not an optimal currency zone. The inability of countries within the eurozone to obtain the benefits of a floating currency to absorb shocks and changes in competitiveness, combined with these structural rigidities, has meant that the extreme monetary policy being followed by the ECB is having increasingly little effect.

There is a wider issue, however, caused by the extreme use of monetary policy and that is the distortions it causes to the economy and to investment decisions. In terms of the economy, it reduces the potential growth rate by allowing zombie companies to survive at the expense of healthier ones which are better able to stimulate economic growth. Zombie companies may be able to survive by servicing their debts at very low interest rates but not to invest for the future or pay back their debts when the time comes. But, in surviving, they crowd out the healthier companies which damages a country's growth potential. Particularly in the eurozone, because of negative interest rates, the effect on the banking sector is harmful. Although the ECB is taking some measures to alleviate the pain for eurozone banks whose reserves at the central banks are earning negative interest, the effect on margins is harmful. It is difficult to charge many customers negative interest rates and it reduces the banks' net interest margin on loans. It can act as a disincentive to lend which obviously has a negative impact.

The extraordinary state of the bond market, as evidenced by the yields on ten year government bonds shown at the beginning of this memorandum, poses dangers for investors. At the time of writing this, US$14 billion of bonds stand on negative yields so that, if held to maturity, holders who buy now are guaranteed to lose money and since when was this a good idea? There are some investors who have to hold debt for matching purposes, but why would anyone else want to buy a sure loser if this investment was held to maturity? Very briefly, because we have written about this before, it might be that the investor fears the banks will fail and, therefore, his or her deposits are lost. It might also be because of a belief that deflation would take hold so that the final negative return on a bond will be less than the fall in the price level. Finally, if the investor was a real gambler (and some have made money this way recently), he or she might believe the "greater fool theory" whereby somebody else would buy the bond on an even greater negative yield, thereby providing a profit. We think it unlikely that there will be major bank failures or that there will be an extended period of deflation and we certainly would not punt on negative yielding bonds hoping to sell them to a "greater fool" at a profit.

It does seem that many economies can only survive on these ultra low or negative interest rates and it is going to be very difficult to wean economies off current interest rate levels without causing upsets in securities markets. These levels of interest rates seem to be a given and it is difficult to see when there will be a meaningful move towards what were historically considered normal levels. However, it remains vital to emphasise that, as and when bond yields and interest rates return towards, or even partly towards, what were considered normal levels, there will be significant losses for investors. Apart from this, many investors require income and good quality bonds offer little, nothing or even a negative return. The temptation is then to move down the quality curve but, if the world economy is in a period of low growth, the risks of default in lower quality credits increases.

Because we find fixed interest securities so unattractive and the dangers of investing in the market so obvious, we retain our preference for equities as the most suitable long term asset class if the mandate permits. To argue the fundamental case for bonds means stretching a justification beyond anything which is realistic. Short term punts might make money but it is a policy full of risk and the defence to explaining losses if interest rates rise would be very weak, especially if the bonds were bought on a negative yield. If bond yields show some reversion to mean and stay at more normal levels thereafter, then bond investors' losses would not be recovered whereas with equities, on the reasonable assumption that the long term price trend is upwards, short term price falls are likely to be more than recovered over time.

It seems that the world economy is, to varying degrees, depending upon the country in question, reliant for even modest growth on very low interest rates and in many countries these are negative in real terms. If interest rates were to move towards more normal levels, it is hard to imagine how their economies would cope. The working premise of many economies now is that interest rates will remain very depressed and economic decisions taken and policy made on that basis. For instance, if interest rates were at normal levels, governments and businesses would not feel so comfortable about borrowing so much, given the servicing costs of the debt. Yet if borrowing had been limited by such constraints, the performance of the world economy would have been worse.

So, our case for equities is that, even with only very modest economic growth, the profitability of companies should be sufficient to maintain dividend levels overall. The yield advantage which shares enjoy in many countries over their governments' bonds is important, not only for the income it provides for investors but because it supports their relative valuations against bonds. Just one very simple example makes the point. One of the most reliable companies for investors has been Nestle, where the gross dividend yield is 2.3%. The Swiss government ten year bond has a gross redemption yield of -0.737%. With such a large yield difference, it is highly likely that the equity will be a more attractive investment than the bond over the latter's life. With the importance of yield paramount for many investors, valuation levels might seem less important than the prop to share prices provided by dividend yields. That this has to be one of the main supports for equity prices shows the topsy-turvy economic world in which we find ourselves.

It might seem strange to those who have experienced times of high inflation to be living through a time when central bankers are worried about the lack of inflation and its failure to meet their targets. Nobody should be complacent, however, because, with monetary policy so loose, inflation could rear its ugly head. If that does happen, holding shares, which represent real assets, could also be a good hedge. Gold has been a good market recently, benefiting in uncertain times as a store of value and also because current interest rate levels do not make its lack of an income a disadvantage.

For sterling based clients, the UK's political uncertainty continues to be a major worry. As we have often said in these reviews, it is not so much Brexit which is the issue but the possibility of a new government coming into power with extreme policies which would be highly damaging to markets and sterling. We are no closer to knowing how all this will work out, but avoidance of unnecessary risks remains paramount and the potential risks in the UK are very significant. For this reason, we continue to hold, where the mandate allows, the majority of our clients' investments in overseas securities and in an unhedged situation. In the right circumstances, current UK market levels would look attractive but to increase UK exposure at this stage would be an unnecessary risk.

Although markets have shown a positive return over the last quarter and have shown a strong performance year to date, the distortions caused by the use of extreme monetary policy and the growth of protectionism, as evidenced by the various trade disputes taking place, notably between the USA and China but threatening to bring in the EU in a much bigger way, means that market volatility is always likely and we have seen this at an early stage in the quarter which has just begun. For the reasons mentioned, shares remain our favoured asset class, but returns so far this year have exceeded expectations and so some caution about this is in order and negative quarters are bound to be experienced. But we are long term investors and we do not believe that the background is so bad as to change our policy. Above all, sterling based investors must be positioned to insure against the risks evident in the UK.