meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been a solid quarter for international equity markets, with the recovery shown in the second quarter being consolidated at a time when bond performances have been mixed. In the currency markets, sterling has strengthened against most currencies. Gold, whilst off peak levels, has moved modestly higher.

The tables below detail relevant movements in markets :

International Equities 30.06.20 - 30.09.20

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-0.6	-1.1	+3.5	-0.8
Finland	+9.4	+9.2	+14.2	+9.4
France	-1.3	-1.5	+3.1	-1.3
Germany	+4.1	+3.8	+8.6	+4.1
Hong Kong, China	+1.5	-3.0	+1.5	-2.8
Italy	-2.1	-2.3	+2.2	-2.1
Japan	+4.8	+2.4	+7.2	+2.7
Netherlands	+1.7	+1.5	+6.2	+1.7
Spain	-7.4	-7.5	-3.3	-7.4
Switzerland	+1.9	+0.4	+5.1	+0.6
UK	-3.9	-3.9	+0.5	-3.7
USA	+9.5	+4.7	+9.5	+4.9
All World Europe ex UK	+1.8	+1.1	+5.8	+1.3
All World Asia Pacific ex Japan	+8.0	+4.6	+9.5	+4.9
All World Asia Pacific	+6.8	+3.8	+8.7	+4.1
All World Latin America	-0.6	-5.4	-1.0	-5.2
All World All Emerging Markets	+8.7	+4.5	+9.3	+4.7
All World	+7.0	+3.4	+8.2	+3.6

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -0.9%

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

Currency	30.06.20	30.09.20
Sterling	0.17	0.23
US Dollar	0.66	0.70
Yen	0.02	0.01
Germany (Euro)	-0.46	-0.53

Sterling’s performance during the quarter ending 30.09.20 (%)

Currency	Quarter Ending 30.09.20
US Dollar	+4.3
Canadian Dollar	+2.3
Yen	+1.8
Euro	-0.1
Swiss Franc	+1.4
Australian Dollar	+0.4

Other currency movements during the quarter ending 30.09.20 (%)

Currency	Quarter Ending 30.09.20
US Dollar / Canadian Dollar	-2.2
US Dollar / Yen	-2.1
US Dollar / Euro	-4.1
Swiss Franc / Euro	-1.4
Euro / Yen	+2.0

Significant Commodities (US dollar terms) 30.06.20 - 30.09.20 (%)

Currency	Quarter Ending 30.09.20
Oil	+0.8
Gold	+6.3

MARKETS

International equity markets broadly held on to their second quarter gains in the third quarter meaning that, for investors exposed to international markets, portfolios are at around their end 2019 levels. For the third quarter, the FTSE All World Index returned +7.0% in local currency terms, +3.4% in sterling terms, +8.2% in US dollar terms and +3.6% in euro terms. Looking at local currency returns first, the stand out market was the USA where the FTSE USA Index returned +9.5%. There were also above average performances from the FTSE All World All Emerging Markets, +8.7%, and the FTSE All World Asia Pacific ex Japan Index, +8.0%. On the other hand, there were below average performances from the FTSE UK Index, -3.9%, the FTSE Australia Index, -0.6% and the FTSE All World Latin American Index, -0.6%. The FTSE All World Europe ex UK Index was also an underperformer, returning +1.8%. Within that index, the FTSE France Index, -1.3%, the FTSE Italy Index, -2.1%, and the FTSE Spain Index, -7.4%, were notable underperformers, whilst the FTSE Finland Index, +9.4%, and the FTSE Germany Index, +4.1%, were notable outperformers. Turning to the sterling adjusted indices, much the same pattern emerges, although the weakness of the US dollar meant that the return on the FTSE USA Index pulled back to +4.7%, whilst currency movements also pulled back the return on the FTSE All World Asia Pacific ex Japan Index to +4.6% and the FTSE All World All Emerging Markets Index to +4.5%, all still very respectable performances.

The performances of international bond markets as measured by ten year government benchmark bonds were mixed. The gross redemption yield on the UK government bond rose by 6 basis points to 0.23% and on the US Treasury by 4 basis points to 0.70%. On the other hand, the gross redemption yield on the ten year JCB was almost unchanged, down 1 basis point to 0.01% and that for the German Bund was down by 6 basis points to -0.53%.

As indicated above, the US dollar was weak during the quarter. Against the US dollar, sterling rose by 4.3%. It was also stronger against the Canadian dollar, +2.3%, the yen, +1.8%, the Swiss Franc, +1.4% and the Australian dollar, +0.4%. It was slightly weaker against the euro, falling by 0.1%.

In the commodity markets, oil, as measured by Brent crude, rose 0.8%, whilst gold, although off its peak levels, rose by 6.3%.

ECONOMICS

On the surface, there seems a significant disconnect between international equity market movements and the real economy which has been so severely damaged by the Covid-19 pandemic. For the latest quarter and the year to date, international equity markets are little changed and, although there was a period of weakness in September, markets showed some recovery at the end of the month, and that in the face of a disturbing rise in Covid-19 cases in many countries. The answer to this apparent departure from reality by markets is that the rules of economic management and drivers of stock prices have been rewritten since the Global Financial Crisis, and it has been important that investors and investment managers have been able to adjust their thinking in the light of these developments. The rationale for our view that equities are our preferred long term asset class has not changed, hence the consistent theme of our economic review.

It goes without saying that 2020 is going to be a year of severe recession for the world economy. In its latest economic outlook, published in September, the OECD now forecasts, although stressing the considerable uncertainty, that the world economy will contract by 4.5% this year, an improvement from its "single hit" scenario in June, when it forecast a contraction of 6%. "Single hit" refers to one Covid-19 wave. Within this figure, its forecast for the G20 countries is growth of -4.1% for this year, compared with its June forecast of -5.7%. However, whilst the overall picture looks less bad, if the OECD projections are correct, there has been a significant deterioration in the outlook for some of the G20 members since its June projections. For example, the OECD now projects growth of -10.2% for Mexico, a deterioration of 2.7%, growth of -11.2% for Argentina, a deterioration of 2.9%, growth of -10.2% for India, representing a particularly large deterioration of -6.5%, and for South Africa growth of -11.5%, a deterioration of 4.0%. On the positive side, there has been quite a big uplift in its forecast for the USA where the growth rate is put at -3.8%, an improvement of 3.5% and, nearly everywhere else in the G20, apart from those countries mentioned above, the forecasts are less bad than in June. Importantly, China is now expected to grow by 1.8% this year which represents a major improvement on the OECD's June forecast of -2.6%. All these projections are based on its "single hit" scenario. For next year, the OECD sees a recovery in the world economy of 5.0%, which would take it back to where it was at the beginning of 2020. If the OECD's projections are anywhere near correct, the country in the best position would be China, where it currently projects growth of 8.0% in 2021 to come on top of the 1.8% it now projects for this year. Of the other G20 countries, only South Korea, Turkey and Indonesia are projected to have grown to a level above their starting position in 2020. But, whichever way one looks at this, whether pessimistic because of the magnitude of the economic recession which has been caused, or more optimistic because of the recovery in the world economy which is expected next year, the incontrovertible fact is that a substantial amount of economic growth has been lost for ever.

Faced with this unprecedented situation, policy members, whether in government or the central banks, have pulled out all the stops to address the economic and financial side of this catastrophe and the Global Financial Crisis (GFC) of 2007-2009 provided some guidance. The long term consequences of their monetary and fiscal actions will be very significant but, for the moment, it is necessary to address the short term problems, which are immense, and the actions which they have taken explain the performance of equity and bond markets from 23rd March when the equity market recovery started following its precipitous fall over the previous month.

What governments are trying to do with their fiscal measures is to save their economies and as many jobs as possible, generally trying to distinguish between those parts which are sustainable, with their associated jobs, whilst realising that it will not be possible to save companies which were only hanging on beforehand by virtue of being able to service their debts because interest rates were so low. The UK Chancellor of the Exchequer spelled out the limitations of what was possible when he announced his latest measures towards the end of September, taken in the context of a spike in Covid-19 cases in the UK but, of course, this applies elsewhere as well. The trade off between protecting the health of a nation, on one hand, and the economy, on the other, is extraordinarily difficult, but any finance minister will want to ensure that, when the pandemic is over, viable businesses have the prospect of growth and their employees jobs. There are two aspects to this. One, which we have often discussed in these reviews over the years since ultra low interest rates have been in place from the time of the GFC, is the effect on the long term prospects of an economy of zombie companies crowding out those with better prospects by virtue of being able to survive because their debt servicing costs were so low. They are effectively holding back companies which are likely to be more successful and thereby collectively holding back the potential growth rate of an economy. It is unlikely that many companies in this category will come through the present economic crisis. It is to be hoped that those with much better prospects will be able to survive as a result of measures which many governments are taking to support them during the crisis. So, this is one angle, namely government attempts through various measures to enable viable companies, temporarily experiencing a fall off or cessation of income, to return to their normal business when the pandemic has passed. Another issue is playing out, and one where market forces will come into play, and that is the long term viability of some sectors, or if not their viability, then their size in the face of a change in their longer term fundamentals. Some companies have clearly benefited from lockdowns imposed around the world. Some areas of the technology sector are a case in point as many employees have worked from home. The move to online ordering of goods has benefited companies like Amazon (although its costs have risen substantially, too). Some trusted branded goods in the food industry have done well as people have done more home cooking and some healthcare companies have also done well. Many of these companies are likely to lock in benefits derived from changing spending or working patterns during lockdown. But there are some very obvious losers, like companies in the leisure and travel industry, and not all of them will get through this crisis. So, once this is over, governments will be faced with much higher levels of unemployment and a very different economic outlook.

For the moment, however, governments are using extreme fiscal policy to try to steady their economies and, with it, are borrowing mind blowing amounts of money. In its latest review, the OECD has 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 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.

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 Peoples 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 around 40% and that of the Bank of Japan by about 15%. The Bank of England's balance sheet has increased by over 50% 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 sheet shows, 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 for 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.

Even though we believe that equities hold more attraction than other asset classes, it does not mean that one can be comfortable with the reasons why they have performed well. Vast quantities of newly created money chasing a limited amount of assets and driving up prices makes one wary. Markets are hugely distorted as a result of the extreme monetary policy being followed. Furthermore, very low or negative interest rates are effectively underwritten by most central banks for the foreseeable future which has implications for different asset classes. In normal times one would expect interest rates to fluctuate with the economic cycle and one could never have full confidence in one's forecasts. Whilst not 100% certain, the level of confidence which economists and investors have in their interest rate forecasts for the foreseeable future cannot be far off 100%. In a significant recent development, the Federal Reserve has softened its policy further. Instead of trying to achieve an inflation rate of 2%, the Federal Reserve is prepared to average out the inflation rate over a number of years. With inflation currently undershooting its target, it can take this into account in averaging the rate, which means it will tolerate an inflation rate of over 2% for a time. Under the former rules and absent an extreme situation, such as we have at present, one would be expecting the Federal Reserve to be raising interest rates. This will not now be the case.

With central banks hoovering up bonds with newly created money, bond investors can feel that they can be relatively unconcerned about the size of issuance. In normal times, they would be looking for higher yields if governments kept coming to the market for money. With the central banks exercising financial repression through the application of their monetary policy, including yield targeting, bond investors can feel more relaxed about the current level of interest rates, even though they need to be very wary about the longer term and any reversion to mean in yields on fixed interest securities which would land them with some significant capital losses. This is the reason we are negative on the outlook for bonds. The yields they offer cannot possibly meet anyone's realistic investment aspirations.

These ultra low interest rates continue to have positive messages for shares. With the risk free rate so low, the net present value of a company's future earnings is higher than if interest rates were higher and, so, if one can be reasonably sure that interest rates are going to remain very low, or even negative, that does give a pointer to shares but, of course, not at any price. But it does mean shares can endure a higher rating than in the past. For example, the forward price/earnings rate on the S & P 500 is estimated to be somewhere around 22, which means the earnings yield, the reciprocal of this, is around 4.5%, which compares favourably with the yield on the 10 year US Treasury bond of 0.70%. The dividend yield on the S & P 500 at around 1.8%, whilst low in absolute terms and even allowing for uncertainty about dividends, is still considerably higher than on a high quality fixed interest security like a US Treasury bond. Now, of course, if the discount rate applied to future earnings had to rise because interest rates were rising sharply or the view of future earnings became more pessimistic, the justification for higher share prices would be much less and that may be an issue for the future.

One subtle, but important, change in the Federal Reserve's recent statement about its treatment of inflation for policy purposes opens up the prospect of higher inflation down the line. With very easy monetary policy stretching back to the GFC and huge amounts of money creation having taken place, one might have expected inflation to become an issue by now, at least up to the time of the pandemic. But money has been moving around slowly, probably because confidence has not been high, and, in the short term, inflation is unlikely to become a problem. However, if one can visualise a position in the USA when inflation rises above 2% but, because of the new averaging formulae, no action on interest rates is taken, real interest rates would become even more negative. The normal monetary response to higher inflation would not have been activated and, if there was an increase in the velocity of circulation as businesses and individuals became more confident, it is easy to see inflation increasing as supply constraints emerged. This scenario would definitely be bad for bonds as, in a situation such as this, central banks could, when their policy parameters allow, be starting to reverse QE. The attraction for equities would be that they would represent real assets, which would be a better investment in an inflationary environment. This is for the future and, for now, all efforts of politicians and central bankers are being concentrated on getting through the present problems.

Clearly, investors are concentrating on the short term, as they have to, and the monetary and fiscal policy being followed by most countries is supportive to stock markets for the reasons we have already given even if those reasons are not high quality ones. At the back of our mind, we should be mindful of what the longer term consequences will be of the economic actions now being taken. When the world economy emerges from this pandemic, it will look different. Some industries will flourish, others will wither, but the aim is for economic growth to resume. However, astronomic sums of debt have been taken on and dealing with this problem will exercise the minds of finance ministers when this is all over. Enormous levels of debt and, probably, continuing large budget deficits, will be the legacy. Amongst others, the UK Chancellor has marked the country's card on this future problem. The normal economic remedies would be to raise taxes, cut public spending or a mixture of the two. The difficulties will arise from the fact that many economies will be in a fragile state and, whilst they may be growing again, it would not take much to derail them. Rising taxation levels would not only take spending power out of individuals' and companies' pockets, but it would act as an economic disincentive for them to spend or expand. Cutting public spending would be the better option, but that is not going to be easy to do in an environment which would almost certainly see much higher unemployment levels. What has made the explosion of public debt and budget deficits less catastrophic at the moment is the extraordinarily low level of interest rates which has kept down debt servicing costs. The easy answer is to hope that central banks will continue to maintain interest rates at ultra low levels and indulge in even more QE. However, whilst investors understand and are prepared to tolerate current levels of debt issuance and overall debt levels, they are unlikely to do so indefinitely. One could argue that, if all major central banks are doing this, then there is strength in numbers and an attack on one currency or one government bond market is less likely. That is probably wishful thinking. If one currency and/or bond market comes under attack, the knock on effect in terms of credibility and its economic consequences would be severe and disruptive to the world economy. This is for the future and we will need to see how matters develop, but these potential problems must be borne in mind and should be an antidote to complacency arising from the stock market's steady performance.

In normal circumstances, we would probably be concentrating our economic review on the forthcoming U.S. elections and Brexit, but, not surprisingly, two important events like these have taken second place to Covid-19. As far as the U.S. election is concerned, given the checks and balances in the U.S. constitution, a split result, where neither party controls all three arms of the executive and legislature, is often not a bad result, since it is more difficult to enact controversial policies. The Democrats have shifted leftwards and, if they were to control all three arms, it might be reflected in U.S. stock prices for a while. This is pure speculation, because everything seems to be up in the air at the moment. As far as Brexit is concerned, Covid-19 has overtaken events and any short term issues over Brexit are likely to be subsumed into the problems which the pandemic is causing for the UK and EU economies. So, even if there is not a trade agreement with the EU, the damage caused to both sides, the EU and the UK, by the pandemic, is likely to overshadow Brexit in the short term. This might seem an extraordinarily short dismissal of two very important events but, such is the magnitude of the economic effects of the Covid-19 pandemic and the policy response to it, that this reflects current reality. We will, no doubt, come back to these two issues, and others, when the pandemic has become less of an issue, perhaps because an effective vaccine has been discovered.

Whilst, the overall performance of markets so far this year, up to the end of September, has been satisfactory in such extraordinary circumstances, the breakdown of various countries' performances is instructive, particularly that of the UK, which has significantly lagged the world stock market by virtue of the market's profile, with an important emphasis on value stocks which have been completely out of favour. The lack of technology stocks, compared with the USA, is one reason for the large disparity in performances between the two markets. The point we want to drive home is that, unless there is a specific mandate, which, of course, there might be for good reasons, home bias is to be avoided. When investors have the freedom to invest internationally, they should do so to minimise the danger of concentration risks.

None of us has a crystal ball and short term market movements are always difficult to divine. We cannot be complacent given how bad the economic background is but we should take into account the assistance which a long period of ultra low or negative interest rates gives to equities and that the continuation of this extreme monetary policy is inevitable for the foreseeable future. This raises the relative attraction of equities, with fixed interest securities, in our view, deeply unattractive on these yields on a long term perspective. Given the background, we must expect some negative quarters but our longer term view remains that international equities are our preferred asset.