



meridian
ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

International equity markets have broadly maintained the gains shown earlier this year, notably in the second quarter, but the fixed interest market continues to underperform equities and the reasoning behind this forms an important part of this review. Markets continued to be influenced by events in the Middle East in the short term and the parlous state of a number of important countries' fiscal positions.

The tables below detail relevant movements in markets :

International Equities 30.06.26 - 30.09.26

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+1.2	+1.5	+1.6	+2.3
Finland	-1.1	-1.9	-1.8	-1.1
France	-4.6	-5.3	-5.2	-4.6
Germany	+1.1	+0.4	+0.5	+1.1
Hong Kong	+8.1	+8.0	+8.0	+8.8
Italy	-0.4	-1.1	-1.0	-0.4
Japan	+2.0	+5.5	+5.5	+6.2
Netherlands	-3.6	-4.4	-4.3	-3.6
Spain	+1.6	+0.8	+0.9	+1.6
Switzerland	-2.6	-6.0	-5.9	-5.3
UK	+1.9	+1.9	+2.0	+2.6
USA	+2.5	+2.4	+2.5	+3.1
All World Europe ex UK	-1.2	-2.6	-2.5	-1.8
All World Asia Pacific ex Japan	-2.6	-0.2	-0.2	+0.5
All World Asia Pacific	-1.2	+1.5	+1.6	+2.3
All World Latin America	+5.1	+3.8	+3.9	+4.6
All World Emerging Markets	+2.0	+1.6	+1.7	+2.3
All World	+1.3	+1.6	+1.7	+2.4

Source : FTSE All World Indices

FTSE Actuaries UK Conventional Gilts All Stocks Index (total return) : -2.5%

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

	30.06.26	30.09.26
Sterling	4.76	5.42
US Dollar	4.46	5.27
Yen	2.69	3.07
Germany (Euro)	2.86	3.58

Sterling's performance during the quarter ending 30.09.26 (%)

	Quarter Ending 30.09.26
US Dollar	+0.1
Canadian Dollar	+0.2
Yen	-3.2
Euro	+0.8
Swiss Franc	+3.4
Australian Dollar	-0.5

Other currency movements during the quarter ending 30.09.26 (%)

	Quarter Ending 30.09.26
US Dollar / Canadian Dollar	+0.1
US Dollar / Yen	-3.3
US Dollar / Euro	+0.5
Swiss Franc / Euro	-2.5
Euro / Yen	-3.9

Significant Commodities (US dollar terms) 30.06.26 - 30.09.26 (%)

	Quarter Ending 30.09.26
Oil	+42.1
Gold	+3.2

MARKETS

- A solid performance from international equity markets which consolidates the first half's gains. In local currency terms, there were above average performances from the USA and Latin America, whilst there were below average performances from Asia Pacific ex Japan and Europe ex UK. In sterling adjusted terms, Japan showed a meaningful outperformance.
- It was a different story for the fixed interest market which, again, underperformed the equity markets, unsettled by the prospects of higher inflation and the weak fiscal position of a number of countries.
- The feature of the foreign exchange market was the recovery of the yen and the weakness of the Swiss Franc.
- In commodity markets, the oil price reflected developments in the Middle East and, specifically, restricted passage through the Strait of Hormuz.

ECONOMICS

Although economics is regarded as a “dry” subject and the butt of jokes, for example the two handed economist “on the one hand but, then, on the other” suggesting indecisiveness, its importance for governments in guiding policy making and for investment managers in the area of asset allocation is very high. Obviously, at government levels, political ideology will shape what may be the desired outcomes of economic decisions and tax and spend policy but objective economic analysis can usually arrive at more realistic conclusions. Certainly, in the way we define our investment policy at Meridian, economics is central to our thinking. We try to avoid giving political views for that can distract attention from the focus on investment policy, rather we analyse the effects of what politicians are doing and carry that thinking over to our investment policy.

One of the unwelcome observations about current day politics is how little politicians seem to understand or care about the economic outcomes of what they are doing. Actions have consequences and it is disturbing to find that many politicians seem to ignore this inconvenient fact. This would be bad enough if the world economy was running smoothly but it is not and the serious geopolitical and economic position with which politicians are faced demands an informed response.

Our clients will know from these reviews that we have long held a negative view on the fixed interest market based on our economic analysis of the current situation which has largely been informed by the unsustainable levels of budget deficits being run in important countries allied with the high overall level of government outstanding borrowings in relation to GDP. The Iran war and its inflationary consequences have aggravated the position. We can have in mind countries like the USA, the UK, France, Italy and Japan, most of which have both the attributes just mentioned. Some of the politicians in these countries are aware that their countries' borrowing position is unsustainable but many,

including those in office, appear oblivious to the problems which are developing. Actions, or, in these cases, inactions have consequences, as we have said, and, as our readers will understand, they include the following. If a country cannot grow at a fast enough rate to prevent its outstanding debt level from increasing, and that is the case for the countries mentioned above, then it is likely to be in trouble sooner or later. Why is that? The budget deficits, which are causing outstanding government debt to grow, have to be financed by selling more government debt and there comes a time when lenders say that they want a higher absolute or relative rate of interest or, in extremis, they may not lend at all. This difficulty is analogous to an individual who keeps trying to borrow more from his or her bank. The bank will eventually say “no more”. For heavily indebted countries, the collapse in confidence could well hit the exchange rate, one reason being that existing holders of that country’s debt may sell part or all of it and the relevant currency along with that. If the exchange rate weakens, imported products will rise in price thereby pushing up inflation and so the vicious cycle goes on. What might happen next? The UK has experience of this when it had to call on the International Monetary Fund (IMF) for assistance in 1976 but this comes with strings attached, namely effectively taking over the country’s economic policy. Readers may recall that we have previously said that the bond market can be an investor’s best friend, by which we mean that a collapse in bond prices may force the relevant governments to take remedial action to stabilise their finances whether they like it or not. The other action which some countries have taken in the past is to monetise their debt by asking the central bank to finance its deficits by printing money which could be achieved through the central bank directly buying newly issued government debt. This would debase the currency, besides being illegal in some countries, and lead to hyperinflation as has been seen where it has been tried. Of the countries mentioned above as having debt problems, this would not be open to France and Italy as members of the eurozone. This course of action is very unlikely in developed countries although something like it occurred in Covid but central banks have attempted to reverse this action through Quantitative Tightening (QT) whereby bonds have been sold back to the private sector. We have ignored the possibility that a country may seek to inflate down its debt problem but no serious country would try to do this because of the dangers of hyperinflation.

This concern is not theoretical because, as this is written, there are clear signs of serious stress in bond markets. Of the countries mentioned earlier on in this review, all their maturities are showing stress, 2 years, 10 years and 30 years. For example, the 10 year US Treasury bond broke through the 5% level during the quarter and is well over that level now (5.30% at the time of writing). The 10 year UK gilt has pushed well over the 5% level during the current quarter (it now stands at 5.45%) whilst the UK’s 30 year bond almost reached a 6% yield at one stage (now 5.97%). But perhaps the most serious immediate sign of stress is in the French bond market. France is, of course, the second largest country in the eurozone and, if we look at its 10 year government bond as a good example, the point is made. Its gross redemption yield is now well above those of Italy and Greece and the gap in yield with the 10 year German government bond is now around 137 basis points when, until recently, it had been trading at a still very large 80 basis points premium. This is a serious development. Very highly indebted Italy, like France, has also seen a particularly sharp spike in yields over the last quarter as it struggles to get its budget down to EU mandated levels. And in the most indebted of all these countries, Japan, the 10 year government bond yield has broken through 3% (currently 3.08%), an astonishing level given minuscule yields from Japanese government bonds in recent years.

Why have the bond markets been so stressed? A general issue, not specific to these countries, is the rise in the oil price caused by the Iran war and its consequent effect on inflation. This has already caused central banks, though not yet the Bank of England, to raise interest rates and the bond markets are reflecting inflation expectations. But there are specific reasons in the case of the countries detailed above which have concerned investors and are reflected in bond yields. The USA has the largest budget deficit, estimated by the Economist Intelligence Unit at 6.5% of GDP this year, and with a string of such deficits in prospect for as far ahead as the eye can see, not to mention its outstanding public debt of US\$40 trillion, about 123% of GDP. If it were not the USA, with its advantage of having the US dollar as the world’s largest reserve currency, concerns about the country’s fiscal position would be even more elevated. Around 59% of US government expenditure is mandatory

and 15% reflects net interest payments so the discretionary element is around 26%. Neither of the two political parties in the USA is addressing the issue which is a very serious one. Whilst the USA has better growth and productivity prospects than, say, Europe and Japan, it is unlikely to grow fast enough to stem the rise in outstanding public debt. We should mention the competition which government bonds are facing includes huge AI debt related bond issues, an important factor in the US bond market.

It is generally agreed that the best way to tackle fiscal deficits is through economic growth on the basis that a growing economy will produce more tax revenues and help to contain spending on social security, unemployment benefits, being one example. However, economic growth just does not happen by chance as it has to have an environment in which this can occur by which we mean fiscal and regulatory tailwinds. Despite economic measures in the USA, like tariffs, of which many economists would disapprove, tax cuts and easing regulations suggest that a pro investment, pro business attitude is foremost, although tax cuts have exacerbated the poor fiscal position described above. But for the other four countries, which we mentioned above, growth prospects in the near future are poor and so do not appear to be a catalyst for an improvement in their fiscal positions. If we take the UK and France, for example, their fiscal predicaments look fairly intractable at the moment. Without straying into the area of giving political opinions and staying firmly with economics and the resulting consequences of governments' actions, it would be fair to say that in both countries, but for different reasons, there is no will to tackle public spending, one of the ways to deal with excessive deficits. There are contrasting reasons in the two countries. In the UK, although the government has a very large majority, it would not be able to get public spending cuts, particularly on welfare, past its backbenchers. In France, which has seen the collapse of the political centre, both parties on the extreme left and right will also not countenance spending cuts although the RN is now starting to talk about them and have vigorously opposed an increase in the pension age. The new budget, just put forward, does propose some spending cuts but it has to get through the legislature. So, in both the UK and France, one of the policies, public spending cuts, which could improve their fiscal position is facing opposition in their legislatures at the moment. The second way, and the one chosen, is to raise taxes. But, as we have said, actions have consequences and raising taxes is not a good way to stimulate badly needed growth. In the UK, both the personal and corporate sectors have faced big tax rises. To give just one example in the UK, the sharp increase in employers' National Insurance contributions in the 2024 budget is causing companies to consider their staff needs and business lines as well as contributing to inflation. The hospitality industry is one which has been hit hard by various measures including this one. We might also cite an increase in employment regulation which again makes business more difficult through increasing costs and risks. So the choice of tax rises to bring down budget deficits and stay within fiscal rules is very likely to be self defeating because of its negative effect on economic growth. The easy targets are the wealthy and business so, if we look at France, whose stock market has significantly underperformed this year, a temporary increase in the tax which large French companies have had to pay, instead of being temporary has the look of being permanent and the increased tax rate is included in the latest French budget proposals. Companies do not take to the streets to protest, a tactic which has been used before to try to force French governments to back down on measures which are unpopular. So, for different reasons, tackling public spending to try to reduce the fiscal deficit, is off the table, at least on the scale required whilst the measures actually taken on the fiscal and regulatory front are likely to be counterproductive to growth. And this is why there are significant signs of stress in the UK and French government bond markets which is becoming an increasing concern. Italy's position is more bleak than France's in the area of overall public debt in relation to GDP. It stands at around 137% of GDP but its budget deficit is more modest at around 3.0% or a little more. For the moment, although a concern, the fact that its 10 year government bonds sell at about 0.27 percentage points yield less than that of France shows the bond market's relative order of worries.

The spotlight has also moved to Japan, always in the back of many investors' minds, because of its enormous debt levels. The general government debt to GDP level stands at just under 250% whilst the net level is around 140%. The difference is accounted for by the substantial amount of Japanese

Government Bonds which the central bank and other official and public bodies holds. But whichever measure is preferred, it's still an enormous figure. An advantage which Japan has over other countries, such as the ones we have mentioned, is that the vast majority of the debt, about 88%, is held internally, including by the Bank of Japan which holds about 46% of the debt. This means that, unlike in some other countries, the danger of an international flight from Japanese debt is less serious than in the cases of the USA and UK, for example, where there are substantial overseas holders of their governments' debt. However, there is no reason for complacency because some things have changed. For one, inflation has become an issue, whereas in the past it has been deflation. This has pushed up interest rates and, as mentioned earlier, the 10 year Japanese Government Bond (JGB) yield has broken through 3%, the highest level for 30 years, whilst the 30 year JGB's yield stands at well over 4% (now 4.16%). Concerns over the relatively new prime minister, Sanae Takaichi's economic plans with their huge spending aspirations and the resulting effect on the bond market have elevated investors' concern. The rise in JGB yields has also caused collateral fears. At the end of July, Japan held US\$1.104 trillion of US Treasury securities and remains the largest holder of US government debt. US interest rates have, for a long time, looked attractive against the minuscule yields on Japanese Government Bonds ("JGB") but the relationship is now less unattractive and the fears in the US Treasury must be that Japanese investors will reduce their holdings of US government debt, a big vulnerability for the USA given the vast amount it has to borrow each year. The weakness of the yen would also make the exchange rate gain attractive to Japanese investors. At the end of July, we saw the unusual situation of the US selling euros from its reserves to support the yen, something which might not have gone down well with the ECB which had not been informed about this action. So a potential problem for Japan but a different one to that of the other countries we have mentioned. And have no doubt about it, a reversal of the carry trade whereby investors borrowed low interest rate yen to buy higher yielding currencies and assets would have a profound effect on the world economy.

Clearly, inflation expectations have moved up as a result of the Iran war and restricted access through the Strait of Hormuz with movements in the price of oil having had outsized influence on securities' prices on certain days. We have also seen a number of central banks start to raise their policy rates including Australia, Denmark, the eurozone, Japan, New Zealand, Norway, South Africa and the USA. As discussed earlier, these have also fed their way into all bond maturities which have also reflected concern about the levels of debt being run up in many countries, leading to an increase in risk premia. Investment managers, economists and the like can opine on what governments should be doing about their debt problems without the worry of having to face the electorate or even their own parties but government ministers throughout the democratic world do not have this luxury. One has the feeling that ever since exceptional state support for individuals during Covid was introduced and which was instrumental in exacerbating the debt explosion, it is becoming more difficult for governments to tell hard truths about the unsustainability of the present situation. Perhaps the most obvious case is in France, which we discussed earlier. It is difficult to see how this will end well since there seems very little acceptance amongst the electorate of the need to address the country's very serious fiscal situation. As we showed, the stress in the French government bond market is there for all to see. And it's not only in the French bond market that the stress shows. The French equity market has notably underperformed so far this year although part of the reason is idiosyncratic, namely problems in the luxury goods industry where economic conditions in important markets like China have been difficult. The French Presidential election (first round in April 2027 and the second round in May 2027) looks problematic for the country's finances given the views of the parties considered to be on the extreme of French politics and with a good chance of winning the Presidency. There is a further issue for the eurozone in general. Whilst some take comfort that France is in the eurozone and therefore, given that many consider the euro to be a political project which cannot be allowed to fail, the country will, in some way, be bailed out by the ECB, it doesn't alter the fact that, as the second largest economy in the eurozone, any crisis affecting French government bonds cannot be isolated within the eurozone. As things stand, it may take a "fiscal event" to bring matters to a head. "Fiscal event" covers a broad range of subjects from routine budgets to the way it is largely used now, namely emergency measures which need to be enacted to reflect an economic or fiscal

crisis. So, if the current deterioration in the state of the international bond markets leads to a full blown crisis, we may expect some fiscal events. If we take France, for example, a fiscal event might normally be expected to introduce emergency spending cuts and/or tax rises to stop the government's finances spinning out of control. As we have described, the current make up of the legislature militates against public spending cuts whilst the country has surely reached the limit of its ability to weather any further tax increases. If businesses and wealthy individuals were to face further imposts which could receive approval in the legislature, the messaging would be very negative since, as we discussed earlier, the best way to deal with a weak fiscal position is to grow the economy, and actions like these on tax would do nothing to inspire confidence. As the second largest member of the eurozone, the implications are serious. As part of the euro, France does not, of course, have the ability to monetise its own debt, which occurs when a central bank finances its own government's expenditure by buying its debt directly. The European Central Bank would certainly not do this. If a country monetises its debt, all credibility goes and inflation risks rise dramatically. At the moment, it is difficult to see how the French debt problem will resolve itself and nearly every day the yield gap between the range of French and German benchmark government bonds widens. The warning signs are becoming increasingly visible. The ECB has various measures it can take to deal with a crisis in the French bond market but would come with problems and, in particular, Germany to what it might consider a bail out will almost certainly oppose them. A debt crisis in the eurozone would have significant knock on consequences for the area including for the currency which is being weakened by current events. The situation in France is serious and, at the time of writing, school riots underline the country's negative image.

This is also the position in the UK as evidenced by the increasing stress in the UK government bond market. A fiscal event, in the conventional sense, is due on 28th October, namely the Budget and a lot is riding on it. At first glance, the UK looks to be in a better position to tackle the budget deficit since the government has a large parliamentary majority and a less militant populace. We discussed earlier the choices which the government has at its disposal to tackle the oversized budget deficit, namely spending cuts or tax rises or a combination of the two. Again if, as is widely accepted, the way out of the UK's fiscal bind (and the same goes for other countries) is to try to accelerate economic growth, cuts in public spending would be the preferred option. There have already been substantial tax rises for businesses and individuals over the last two years as well as increased regulatory impositions and, whether one agrees with these policies or not, the economic messaging is negative for the UK and these tax and regulatory burdens are inimical to growth. Therefore, the Chancellor of the Exchequer has an unenviable task on 28th October. He must either upset his backbenchers through expenditure cuts in areas where they do not want this to happen but which will give some encouragement to investors or he must risk sending further negative signals about the UK as a place to do business, which would be the case if he raises the tax burden further and risks setting back the UK's economic growth prospects. Like France, the UK faces a serious fiscal problem which has to be addressed and the market is sending strong warning signals. It might be hoped that the next fiscal event in the UK is a conventionally defined one i.e. a normal budget rather than the one which people are increasingly coming to define as emergency policy decisions which are taken as a result of an economic crisis. The UK has a particular problem, which we have often mentioned in the past, namely the amount of index linked government stock which is outstanding. Around a quarter of outstanding UK government debt is accounted for by it, in cash terms about £688.5 billion at the end of 2025. Whilst the low cost of servicing the debt with low inflation in the past might have seemed a good idea at the time, the UK's above average inflation is now making interest and principal repayments more expensive. To put the whole cost of the UK's debt burden in perspective, the UK pays about £110 billion in debt interest a year, and this will rise, representing 8% to 9% of total public spending. So, the message from the UK's 28th October budget will be dissected carefully to see whether decisions are being made which can provide the background for economic recovery or is the easy route being taken which is to raise the tax burden on businesses and those deemed wealthy. As in France, the UK bond market is becoming very impatient.

Warning lights are also flashing in the USA where, as this is written, the 30 year US Treasury bond has hit its highest yield since 2004. The budget deficit as a percentage of GDP is higher than in the UK and France and the overall level of outstanding public debt in relation to GDP is higher than in France (just) and the UK. As we have mentioned before, the USA has what is described as having the “exorbitant privilege” of issuing the world’s largest reserve currency, so there is always a demand for US dollars which perhaps allows the USA to get away with more fiscal laxity than elsewhere. However, as the stress in the US Treasury market shows, it is still subject to the same constraints which affect other heavily indebted countries. The US Treasury is trying to manage the US government bond market by buying back longer dated issues to try to keep down yields and funding these operations by issuing more short term debt in the form of US Treasury bills. Whilst one can see what the US Treasury is trying to do, the USA is spilling so much red ink on its fiscal balance that it seems difficult to believe that it will be successful and, should it fail, it could be self defeating in that it will highlight further the scale of the USA’s deficit problem. As this is written, this looks like what is happening. It is difficult to see how this tactic will work when there is a fundamental problem with the US government’s finances. One of the concerns that investors in US government debt have had is that the new Chairman of the Federal Reserve which is, of course, an independent central bank, might bend to President Trump’s wishes on interest rates. However, the signs appear good in that he will, along with his colleagues in the Federal Reserve’s Federal Open Market Committee, stick to its mandate with its recent interest rate increase perhaps being the first of a number of hikes, depending on how inflation moves. It will be recalled that President Trump has called for interest rates to be cut to 1%. With inflation at 3.4% and GDP growth likely to exceed 2%, such an idea, if executed, would create huge inflation and currency risks. No responsible central banker would entertain such an idea, so there is, at least, some encouragement in this direction.

We have mentioned the even higher level of indebtedness of the Japanese government, although the risks to some extent are mitigated by the predominance of Japanese domestic investors in its government bond market. However, the USA is in some danger, as we have mentioned before, of suffering collateral damage from the rise in Japanese interest rates and its poor fiscal position which, by itself, is causing nervousness in the US Treasury bond market. The yen carry trade has been a favourite amongst investors for a long time whereby investors borrowed yen at very low rates of interest to invest in higher yielding currencies like the US dollar and take a turn on the interest rate differential whilst not suffering currency losses. If the relationship between the two yields becomes less favourable, the US dollar is likely to fall further in value, and the threat of a reversal of the carry trade is very real. With Japanese investors owning US\$1.14 trillion of US government debt, this is one real concern around the stability of markets.

Whilst it is difficult to see any positive messaging from the UK and France relating to steps to stimulate very necessary economic growth, the USA has positive momentum in certain areas, tax and deregulation, which is one reason why we continue to hold a significant proportion of our clients’ assets in the USA.

In the context of the generally agreed view that the best way out of a debt problem is economic growth, it is timely that the OECD Economic Outlook’s Interim Report has just been published. It is, of course, accepted that it is a particularly difficult time for forecasters because of all the geopolitical problems and uncertainty about the course of inflation as a result of the rise in the oil price but projections from influential organisations like the OECD are still very useful. Compared with June’s forecast, it has lifted its 2026 projection for world economic growth by 0.1% to 2.9% and lowered it by 0.1% to 2027 to 3.0%. Its 2026 and 2027 projections for the USA have shown a noticeable uplift, by 0.2% to 2.2% for 2026 and by 0.3% to 2.1% for 2027. For the euro area, it has raised its projection for 2026 by 0.2% to 1.0% but reduced it by the same amount for 2027 to 1.0% also. What is interesting in our discussion on France’s fiscal problems is that the OECD has sharply reduced its forecast for that country for 2026 by 0.3% to 0.4% and by 0.1% to 0.7% for 2027. These forecasts highlight the extent of France’s debt problem because the growth just isn’t there. Interestingly, Spain still leads the way with growth of 2.6% forecast for this year, up 0.4% on June’s forecast and 1.8%

in 2027, up 0.1% on its earlier forecast. Although Italy's forecast has been raised by 0.4% for this year to 0.9% and remains unchanged next year at 0.6%, these growth rates will not help to improve the country's debt profile. Likewise Japan with very modest growth forecasts of 0.8% and 0.7% respectively cannot expect help with its fiscal problems with those growth rates. For the UK, the OECD has raised its growth forecast for 2026 by 0.2% to 1.5% but reduced it by 0.1% next year to 1.0%. These, too, are not growth rates which will start to eat into the UK's debt problems. As usual, what pushes up the projected growth level for the world economy is China and India with respective projected growth rates for this year of 4.5% and 7.1% respectively and 4.2% and 6.5% for next year, high by developed country standards, but in the case of China, quite low by its own record.

Looking at the global picture because of the link between economic growth and public finances, it is difficult to be optimistic about the state of the latter given the short term prospects for the former. What will help will be some resolution of the Iran war which will lead to improved oil flows and a fall back in the price of oil. Central banks, having been behind the curve on raising interest rates as the world emerged from Covid and, wrongly, seeing the rise in prices as transient, will not want to be caught out again, so expectations are that we will see further rises in policy interest rates this time also including the UK. Interest rate increases, of course raise the pressure on public finances even further. So, we can expect the oil price to remain the key determinant of day to day movements in markets.

Our readers at this stage may wonder why we have not been reducing equity positions. For clarity where income is not paid out of portfolios, we have been allowing cash to build up through dividend receipts although always in the context of a significant exposure to equities. There is always the possibility of a sharp and sudden pullback in markets which could be taken advantage of with some liquidity in hand. One reason is a negative one, the obvious alternative, fixed interest securities, as we have tried to show, remain unattractive in our view and to hold a large amount of cash as an asset class of choice rather than for opportunistic reasons, as described above, would be to take an exceptionally negative view of the prospects for equities. In this context, it is noticeable how quickly equities have recovered from unexpected shocks like Covid and the recent wars. It is as if they had never happened. The next issue is diversification within the asset class. We have always invested internationally with the USA usually being our largest area of asset allocation and we have always tried to avoid our clients' portfolios being subject to home bias. With the UK equity market now accounting for about 2.5% of the world equity market and with what we perceive to have quite a high risk level, to be significantly overweight there involves unnecessary risk. The USA, at around 63% of the world market, has long outperformed the UK market. It is a more dynamic, pro business and pro investor country with better productivity and economic growth prospects and investors need to follow the money. We would say the same about parts of Asia. And then there is the question of the attitude of investors to various asset classes. Are bonds the very low risk stabilising influences on portfolios containing equities such as epitomised by the 60:40 equity bond split? This split hasn't done very well recently given the significant underperformance of bonds versus equities. If you believe that most companies are better run than many governments, why wouldn't one follow them?

It is a subjective view, and we can hardly end this review without talking about it, but we believe that investors are being influenced by the effects which AI may have on the world economy. At the time of writing the focus is on the potential harm which AI might create with some very apocalyptic views being put forward. As we have said before, there is always something for investors to worry about and a reason for not investing but if one had been put off from investing by fears of what might occur, one would have incurred a large opportunity cost in terms of investment gains forgone. Also, for the big picture let us stay with the macro story rather than the micro one, the latter which homes in on whether the large investment in data centres will give a good return to those companies investing in them. Aside from the macro economic effects, we can realistically see productivity gains which should lead to faster economic growth and benefits to companies through cost savings or increased spending in marketing or investment. It is a very complex subject but that is the simple central case and we think that it is a compelling one for investors in the equity market, and possibly, later for bond

markets as faster economic growth makes a dent in the debt burden and helps to bring down inflation. For the bond market, this may be wishful thinking but it is not too fanciful. Probably, some countries will benefit more than others. One can see the USA, China and parts of Asia benefiting as they impose fewer regulations and encourage the further development of AI. On the other hand, the EU with its emphasis on regulation and the precautionary principle is already behind in the AI race and there is little to suggest that this situation is going to change. The UK may be somewhere in the middle but it's more difficult to make a forecast here. However, in explaining why equities are holding up so well given the geopolitical and economic problems, it is not unreasonable to assume that investors are looking beyond the present difficulties and to a faster growing economic future. We shall see, but this looks a reasonable explanation for what is happening at present in the equity markets.

Notwithstanding this view, and we are long term investors, it would not be right to end this review without again emphasising the serious current state of the bond market. Red flags are flying all over the place in the face of some countries running unsustainable budget deficits against the background of too much overall indebtedness. It may be that if politicians will not grasp the nettle, the bond markets, and they show every sign of doing this at the moment, will force it upon them. Whilst equities might suffer short term collateral damage, if politicians are forced, however unwillingly, to address the state of their countries' fiscal problems, it should provide a more stable background in the medium and long term for securities markets.

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