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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been a good quarter for international equity investors, although weakness at the end of the quarter as a result of the coronavirus outbreak in China pulled back returns. Bonds benefited from this uncertainty. In the foreign exchange markets, sterling rose against most major currencies as political uncertainties diminished. Oil was weak because of expectations of temporary weaker trends in the world economy as a result of the coronavirus outbreak. Gold benefited from its status as a safe haven in uncertain times.

The tables below detail relevant movements in markets :

International Equities 31.10.19 - 31.01.20

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+6.1	+1.2	+3.1	+3.2
Finland	+5.3	+2.7	+4.6	+5.3
France	+2.0	-0.6	+1.3	+2.0
Germany	+1.4	-1.1	+0.8	+1.4
Hong Kong, China	-2.6	-3.5	-1.6	-1.5
Italy	+1.9	-0.7	+1.2	+1.9
Japan	+1.3	-0.8	+1.1	+1.7
Netherlands	+3.3	+0.7	+2.6	+3.3
Spain	+1.7	-0.8	+1.1	+1.7
Switzerland	+4.2	+4.6	+6.6	+7.3
UK	+1.4	+1.4	+3.3	+4.0
USA	+7.1	+5.1	+7.1	+7.2
All World Europe ex UK	+3.0	+1.0	+2.9	+3.6
All World Asia Pacific ex Japan	+2.6	+0.4	+2.3	+3.0
All World Asia Pacific	+2.1	-0.1	+1.8	+2.5
All World Latin America	+4.7	-1.7	+0.2	+0.9
All World All Emerging Markets	+2.6	+0.5	+2.4	+3.1
All World	+5.0	+3.0	+5.0	+5.7

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.4%

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

Currency	31.10.19	31.01.20
Sterling	0.57	0.52
US Dollar	1.77	1.51
Yen	-0.17	-0.07
Germany (Euro)	-0.41	-0.44

Sterling's performance during the quarter ending 31.01.20 (%)

Currency	Quarter Ending 31.01.20
US Dollar	+2.0
Canadian Dollar	+2.6
Yen	+2.4
Euro	+2.6
Swiss Franc	-0.3
Australian Dollar	+4.9

Other currency movements during the quarter ending 31.01.20 (%)

Currency	Quarter Ending 31.01.20
US Dollar / Canadian Dollar	+0.5
US Dollar / Yen	+0.4
US Dollar / Euro	+0.6
Swiss Franc / Euro	+2.9
Euro / Yen	-0.2

Significant Commodities (US dollar terms) 31.10.19 - 31.01.20 (%)

Currency	Quarter Ending 31.01.20
Oil	-5.0
Gold	+5.8

MARKETS

It has been a solid quarter for international equity markets, although it would have been much better if there had not been a sell off at the end of the quarter in response to the uncertainty about the effect of the coronavirus outbreak in China. In local currency terms, the FTSE All World Index returned +5.0%, in sterling terms +3.0%, in US dollar terms +5.0% and, in euro terms, +5.7%. Of the countries and regions detailed in our table at the beginning of this review, the only negative performance, not surprisingly, came from the FTSE Hong Kong, China index which returned -2.6%. The FTSE USA Index and the FTSE Australia Index were the strongest performers with returns of +7.1% and +6.1% respectively. The FTSE UK Index, although showing a return of +1.4%, was at the lower end of the return range, together with the FTSE Japan Index which returned +1.3%. With sterling generally strengthening over the quarter, some negative returns appeared in the sterling adjusted returns. The best sterling adjusted returns came from the FTSE USA Index, +5.1%, and the FTSE Switzerland Index, +4.6%.

In the fixed interest market, concerns over the coronavirus outbreak in China caused investors to move to bonds at the end of the quarter. Taking ten year government bond yields as the benchmark, we saw the gross redemption yield on UK government bonds fall by 5 basis points to 0.52%, on the US Treasury bond by 26 basis points to 1.51% and on the German Bund by 3 basis points to -0.44%. The exception was Japan where the negative yield reduced by 10 basis points to -0.07%.

In the foreign exchange market, the Conservative Party's victory in December's UK General Election proved a boost to sterling. Only against a very strong Swiss Franc did it weaken, by 0.3%. Against the Australian dollar, sterling rose by 4.9%, against the Canadian dollar and the euro by 2.6%, against the yen by 2.4% and against the US dollar by 2.0%.

In the commodity markets, concern about the economic effect on the Chinese and, hence, world economy, of the coronavirus outbreak affected the oil price which, as measured by Brexit crude fell by 5.1%. Conversely, gold, seen as a safe haven in uncertain times, rose by 5.8%.

ECONOMICS

In its January 2020 World Economic Outlook, the IMF has made a modest reduction in its economic growth forecasts for 2020 and 2021. Against an estimated growth rate of 2.9% for 2019 and an actual growth rate of 3.6% in 2018, it now expects growth of 3.3% in 2020, down from its October forecast of 3.4%, and in 2021 it projects growth of 3.4%, down 0.2% from its earlier projection. The most important implication for investors is that there is an expectation of an uplift in economic growth this year, however modest, and this was probably the reason that local currency returns from international equity markets were so strong in the final quarter of 2019, although, for sterling investors, the strength of sterling cancelled out the gains.

If we look at the breakdown of the projections, we see that the IMF has reduced its projection for Advanced Economies' economic growth by 0.1% in 2020, to take the figure to 1.6%, actually lower than the 1.7% estimate for 2019, whilst its projection for 2021 remains unchanged at 1.6%. Accounting for the slight reduction in this sector's growth projection is a downgrade of 0.1% in the USA's projected growth rate to 2.0% (2.1%) and the eurozone to 1.3% (1.4%). The only upgrade was for Japan where the IMF's expectations for growth this year has been raised by 0.2% to 0.7%. Interestingly, the UK, in the year in which it exits the EU, is forecast to show higher growth for 2020 at 1.4% than that for the eurozone at 1.3%. Within that, the UK's figure is higher than that for Germany (1.1%), France (1.3%) and Italy (0.5%). The main reason for the downgrade in the projection for the world economy lies with Emerging Market and Developing Economies, where the IMF has cut its growth estimate for 2020 by

0.2% to 4.4% (estimate for 2019, 3.7%) and by the same amount for 2021 to 4.6%. The main reason for this is India, where there have been some very disappointing economic releases. The IMF has cut its forecast for this year's economic growth rate in India by a significant 1.2% to 5.8% (2019, estimate 4.8%) and for 2021 by 0.9% to 6.5%. The IMF has raised its projected growth rate for China in 2020 by 0.2% to 6.0% (estimate for 2019, 6.1%), but has slightly lowered 2021's forecast by 0.1% to 5.8%.

However, to misquote the former US Defence Secretary, Donald Rumsfeld, in 2002, there are known unknowns and unknown unknowns. One of the most important known issues with unknown outcomes is the trade standoff between the USA and China. This blows hot and cold, with the latest state of play being a little more hopeful. The first phase of a trade deal has been signed, which effectively means a truce which, for the moment, stops matters getting worse. For the moment, China is committed to purchasing US$200 billion of manufacturing, energy and farm goods this year and next. We have written at length in recent reviews about the damage which a trade war causes. Slowing international trade growth, or a decline, will damage economic growth, whilst protectionism distorts economic decision making, leading to inefficiencies and lower consumer welfare. We cannot know how this standoff will end because it is a battle for the title of the biggest economic power. Whilst this might seem a longer term issue, both parties, in a rational world, have a big incentive to sort out the problem. President Trump wants to be re-elected and a strong economy should improve his chances. The numbers are generally good for him, with unemployment very low, and he will not want these or any other economic numbers to take a turn for the worse. There is certainly a risk in his trade tactics. Whilst President Xi does not have the problems of seeking re-election, with his grip on power seemingly as tight as ever, he is facing increasing problems domestically. Hong Kong is an obvious case in point. Whilst he could stamp down on the civil unrest there by force, such action would look terrible outside China and carries enormous risks. Economic growth in China is slowing down for a number of reasons, one of which is obviously the trade dispute The longer this goes on, the greater the likelihood of trade patterns changing to the disadvantage of China, for instance in the supply of component for products finished elsewhere. As the economy moves away from fixed asset investment towards consumption and the services sector, some slowdown was to be expected, but managing this will be more difficult without a resolution of the trade dispute with the USA. The Chinese authorities have, for some time, been concerned about the growth of the shadow banking sector, given the dangers which a high level of household and corporate debt can cause for an economy if the bubble bursts. They have had to relax policy in the light of the trade dispute but the state of the banking sector's bad loans must be of concern. If the economy slows down more than expected, then bad debts will increase further. The more difficult are economic conditions, the more these will be reflected in unemployment levels. So none of this is good for President Xi either.

Now we have an unknown unknown, the coronavirus, which emanated from Wuhan but has spread. The human concern is obvious and the most important one, but we do not know how serious will be the economic effect. The development of this is completely unexpected and it is impossible to know how widespread will be the consequences. If we look back at the outbreak of SARS in 2001 to 2003, the economies recovered, so, whilst the human dimension is the most important one, the affected economies did recover later. As this is being written, stock markets are having a significant sell off. This is due to uncertainty about the short term effects and uncertainty is what markets like least.

All of this uncertainty would not have been reflected in the IMF's forecasts. As we have seen, whilst it has reduced slightly its projections for economic growth this year and next year, it is still expecting an acceleration of growth compared with 2019. We noted the reasoning behind the downgrade of its projections, namely a downturn in the expectations for emerging markets, notably India. But, on the positive side, the IMF noted tentative signs that manufacturing activity and global trade are bottoming out, a further shift towards more accommodative monetary policy and diminished fears of a no deal Brexit. On the negative side, besides the US/China trade dispute, the political issues surrounding Iran were mentioned. Depending upon how the coronavirus develops, it would not be surprising to see its economic effects reflected in its and other forecasters' projections as they emerge during the course of the year.

As noted above, one of the reasons which the IMF gave for more optimism was the move to more accommodative monetary policy in some areas. Despite reasonably solid economic numbers from the USA, monetary policy in the USA has been in reverse for some time with three interest rate cuts already and the size of its balance sheet starting to increase again. This is because it has been buying very short dated assets from the banks following an unexpected blow up in the repo market last September when overnight interest rates shot up and the Federal Reserve had to step in to provide liquidity. As a result, the Federal Reserve's balance sheet expanded, as it did when it was acquiring bonds. Buying very short dated assets like Treasury Bills from the banking system to provide liquidity is unlikely to have the same monetary transmission effect as buying longer dated bonds but it looks like more quantitative easing at the very short end of the market. The total assets on the balance sheet of the US Federal Reserve are around US$4.1 trillion, up from a recent low point of around US$3.7 trillion towards the end of last year. When it announced in October that it would buy Treasury Bills to avoid the unexpected strain experienced in money markets in September, it said it would start at an initial pace of US$60 billion a month and continue those purchases until the second quarter of 2020. The problem may have arisen because bank deposits held at the Federal Reserve had fallen in the wake of the Federal Reserve reducing its balance sheet and the banks had become reluctant to lend those reserves. In September, the banks' reserves had fallen to less than US$1.4 trillion, half the level of 2014 when the Federal Reserve stopped buying assets. So, whilst the Federal Reserve's actions at the very short end of the market bear some resemblance to QE, the action has been taken for technical reasons, rather than to manage longer term interest rates with their consequent hoped for transmission effect to the economy. What this action does show is that it is going to be hard to unwind QE. The Federal Reserve was the central bank most advanced in this attempt but it was forced to backtrack.

With sluggish growth in the eurozone and inflation well below the ECB's target level, the ECB restarted its QE programme in November at the rate of €20 billion a month with no time limit on its purchases. The size of the ECB's balance sheet at about US$5.2 trillion, having peaked at US$5.5 trillion after it stopped its bond buying programme, can be expected to rise again and there must be a concern that monetary policy's influence is weakening because, with interest rates so low or negative in the eurozone, one cannot see an extra stimulus or the maintenance of these levels of interest rates as galvanising economic activity. On the other hand, one can see the reversal of QE having a significantly negative impact on economic activity.

If we look at Japan, the size of the Bank of Japan's balance sheet at US$5.3 trillion is approximately the same size as that of the ECB, yet in spite of the amount of QE enacted in Japan, including the purchase of equities through exchange traded funds, the IMF is projecting just 0.7% growth this year and 0.5% next year.

The surprise for some of us is that this enormous expansion of bank balance sheets has not set off a bout of inflation. The transmission effect from the vastly expanded central banks' balance sheets through low interest rates to the economy should, theoretically, have led to much expanded economic activity through loans from banks to businesses for expansion. As money circulated around the economies and activity rose, one might have expected inflationary pressures to arise. After all, that is what might be expected if the money printing machine is turned on. But it has not happened yet. Banks and businesses have been very cautious and low or negative interest rates have been bad for banks. At the same time as their profitability has been squeezed by the current interest rate environment, they are expected to raise their capital position. It is a particular problem for the eurozone's banks because the negative interest rates which have come about because of official policy are difficult to pass on to depositors, which means depressed net interest margins on lending and reduced incentive to lend, especially as the banks have to be comfortable with the trade-off between the size of their net interest margins and the risks in their lending book. So, we are at a stage when the interest rate environment is moving into counterproductive territory and when monetary policy has exhausted its potential to stimulate the economy. When interest rates are as low as they are at present, it is hardly likely that a, say, 0.25% cut in interest rates is going to trigger an upturn in economic activity through business decisions to expand or invest being accelerated. Only really in the USA, of the major economies, are interest rates at levels which provide some opportunity for lower interest rates to be effective and, even here, with the federal funds rate in the 1.50% - 1.75% target band, one must think that the scope for monetary policy to have an effect is limited.

With the benefit of very loose and unconventional monetary policy almost maxed out, it is no surprise that pressure to relax fiscal policy is being ratcheted up. The argument has several aspects to it. One is what one might call a negative one, namely what we have just said, monetary policy easing can offer little more. A second, more alluring one, is that, with interest rates so low, why not take advantage of this once in a lifetime opportunity to lock in current interest rates, especially long term ones to invest in, say, infrastructure, which might have the benefit of contributing to an increase in an economy's long term potential growth rate? There are always investors like insurance companies and pension funds which need to match their assets and liabilities, so the demand may be there. For a government, the costs of servicing medium and long term debt are incredibly low, so this limits the short term strain on the budget. However, the debt burden will increase and will weigh on future generations. It will be worse, as it seems inevitable that interest rates will recover at some stage. So, with the combination of still probable budget deficits having to be financed, and then the refinancing at higher interest rates of the cheap debt which has matured, the hope would be that the benefit of the additional cheaply financed investment will lead to an increase in an economy's long term potential growth rate, which will improve an economy's budgetary and debt profile position as the revenue/expenditure position improves and governments restrain their expectations in the face of better economic prospects. This may be wishful thinking, but one cannot dismiss the idea out of hand and one can see governments being very attracted to it.

Notwithstanding the attraction of cheap funding, not many countries are in a position where they can safely turn on the fiscal taps because budget deficits are already large. The USA did this in 2018 with the Tax Cuts and Jobs Act of 2017 and, although the President will hope that the benefits of a stronger economy will see the initial increase in the budget deficit ease back, not many people expect this to happen. With a budget deficit expected to have been around 4.6% of GDP in 2019 according to The Economist's forecasts, there is no scope for further fiscal expansion. The eurozone is more of a mixed affair. For the eurozone as a whole, the budget deficit for 2019 is estimated to have been around 1% of GDP, a figure which, if applicable to just one country, would leave room for fiscal expansion in the current circumstances. However, the figure hides many different outcomes. It is heavily skewed by Germany, with a 2019 budget surplus estimated to have been around 1.0% of GDP. The Netherlands is also in surplus to the tune of around 0.6% of GDP. But against that, France, the second largest eurozone country, is expected to have blown through the budget deficit limits, with an estimated deficit of around 3.2% of GDP last year, and Italy may have had a deficit of around 2.2% of GDP last year. The pressure is on Germany and, to a lesser extent, the Netherlands to increase public spending to boost the eurozone, but Germany has always had a strong preference for budget discipline. It is possible that the new political landscape in Germany may lead to some relaxation of this view, but one should not count on it. If Germany can be persuaded to relax the purse strings, that would seem the best outcome for the eurozone, since monetary policy, one feels, has very little more to offer. Japan, the world's third largest economy, has recently raised its consumption tax in order to address a weak fiscal position. Its estimated budget deficit last year was around 3.0% of GDP. Whilst the consumption tax rise from 8% to 10% has some mitigating features, with most food items excluded, previous rises have affected economic activity and the fact that the government went ahead with the tax rise reflects Japan's weak budgetary position. China has a large budget deficit, expected to have been around 4.3% of GDP in 2019, but all forecasts for this year must now be in doubt after the coronavirus outbreak which is likely to impact the Chinese economy significantly. Because of this crisis, China is in a different position to other countries and its fiscal position will reflect the danger that the virus is causing to the Chinese economy. The UK is in a better position than many countries. Since peaking at around 10% of GDP in the aftermath of the financial crisis, the budget deficit has fallen to an estimated 1.8% of GDP in 2019. Fiscal policy is now in expansive mode as the country leaves the EU, partly in order to deal with any short term dislocations to the economy.

So, our overall assessment is that there is only limited room for fiscal action in the world economy because of the levels of budget deficits and overall debt levels. Germany has the most scope to take action to complement the ECB's use of extreme monetary policy and that would certainly help the eurozone, but Germany's long standing and constitutional aversion to borrowing is a block on this.

From this overall review, we must conclude that, whilst monetary policy cannot do much more heavy lifting for the world economy because its power to influence economic activity is much diminished, it is not likely to be tightened in the foreseeable future. In our view, that means that the relative attraction of equities remains, even if conventional valuations are strained. The IMF's forecasts for economic growth this year and next imply that corporate earnings should not be under too much pressure and, by extension, the same applies to dividends. Our view on fixed interest securities remains unchanged. Except at the very short end of the market, the capital risk is considerable as and when interest rates start to rise again. Whilst, as mentioned above, we do not think this is likely to happen soon, the distortions to investment and economic decisions caused by ultra low or negative interest rates will build up over time and some action will have to be taken. For instance, the Swedish central bank has moved away from a negative interest rate because of the damage it causes.

As this is written, daily evidence of the negative effect of the coronavirus is becoming apparent. The human tragedy is the paramount concern. The economic effects are difficult to estimate at this stage, but they are clearly negative for the Chinese economy and will have a knock on effect elsewhere. SARS is a precedent and economic activity recovered after a while. At this very early stage of the coronavirus outbreak, because the economic effect, although not the extent of it, will be understood by investors, it should not be a significant market factor, in our view.

Next, a word on the UK. As clients will know, we have, for a long time, been very cautious about the UK in view of the political risk and uncertainty right up to 12th December. For the first time since the referendum on EU membership, there is clarity on the political outlook in the UK for the foreseeable future and also on Brexit in the sense that it has happened, although there is hard work on the detailed agreement to be done. The paradox now is that political risk and uncertainty is much lower in the UK than in many countries, some in the eurozone being an example. The UK therefore merits a place in most portfolios.

2019 was an exceptional year for international equity investors. Whilst we continue to favour equities as the asset of choice for the reasons mentioned above, we must emphasise that we expect an uneven ride, with some negative quarters. Any of the potentially negative issues around, such as US/China trade tensions, Iran or the coronavirus, have the potential to unsettle markets at any time. For the foreseeable future, extremely loose monetary policy is almost certain to be the default position of most central banks. This will be a support to other assets especially equities which, in many countries, provide a higher yield than fixed interest securities, but the level of returns, such as were seen last year, must be considered exceptional and are unlikely to be repeated in the foreseeable future.